

# **The Costs of Tax Compliance of Large Enterprises: Exploratory Analysis of Large Enterprises in New Zealand**

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- Nikolay Shekhovtsev “Business Administration and Costs of Tax Compliance: Deeper Insight into Preventable Costs of Tax Compliance” (Paper presented at the Australasian Tax Teachers’ Association Conference, Melbourne, 2018).
- Nikolay Shekhovtsev “The Cost of Tax Compliance of Large Enterprises: Exploratory Analysis of Large Enterprises in New Zealand” (Paper presented at the Australasian Tax Teachers’ Association Conference, Perth, 2019).



## List of Abbreviations

<b>AU\$</b>	Australian Dollar
<b>BBLR</b>	Broad Base Low Rate
<b>BCP</b>	Basic Compliance Package
<b>BEPS</b>	Base Erosion and Profit Shifting
<b>CA\$</b>	Canadian Dollar
<b>CA-ANZ</b>	Chartered Accountants Australia and New Zealand
<b>CbCR</b>	Country-by-Country Report
<b>CEO</b>	Chief Executive Officer
<b>CFC</b>	Controlled Foreign Company
<b>CFO</b>	Chief Financial Officer
<b>CIR</b>	Commissioner of Inland Revenue
<b>CP</b>	Cost Plus
<b>CUP</b>	Comparable uncontrolled price
<b>DTA</b>	Double Tax Agreement
<b>EU</b>	European Union
<b>FBT</b>	Fringe Benefit Tax
<b>FDI</b>	Foreign Direct Investments
<b>FRA 2013</b>	Financial Reporting Act 2013
<b>GAAP</b>	Generally Accepted Accounting Principles
<b>GDP</b>	Gross Domestic Product
<b>GNP</b>	Gross National Product
<b>GST</b>	Goods and Services Tax
<b>GSTA 1985</b>	Goods and Services Tax Act 1985
<b>HEC</b>	Human Ethics Committee
<b>HK\$</b>	Hong Kong Dollar
<b>ICA</b>	Imputation Credit Account
<b>IDR</b>	Indonesian Rupee
<b>IFA</b>	International Fiscal Association

<b>IR</b>	Inland Revenue
<b>IRS</b>	Internal Revenue Service
<b>ITA 2007</b>	Income Tax Act 2007
<b>MBIE</b>	Ministry of Business, Innovation and Employment
<b>NZ\$</b>	New Zealand Dollar
<b>NZ IFRS</b>	New Zealand International Financial Reporting Standards
<b>NZLS</b>	New Zealand Law Society
<b>OECD</b>	Organisation for Economic Co-operation and Development
<b>PAYE</b>	Pay As You Earn
<b>PE</b>	Permanent Establishment
<b>RPM</b>	Resale Price Method
<b>RWT</b>	Resident Withholding Tax
<b>SME</b>	Small and Medium Enterprise
<b>TAA 1994</b>	Tax Administration Act 1994
<b>TNM</b>	Transactional Net Margin
<b>TPS</b>	Transactional Profit Split
<b>UK</b>	United Kingdom
<b>US</b>	United States
<b>US\$</b>	United States Dollar
<b>VAT</b>	Value Added Tax
<b>XRB</b>	External Reporting board

## **Disclaimer**

The statistics and data provided in this thesis are valid as at 28 February 2019. Any updates or changes which come into effect after this date are not considered in this study.

## **Abstract**

The costs of tax compliance refer to the additional expenses that business taxpayers incur in order to comply with the requirements of tax law. Recognising the negative effects that the costs of tax compliance have on business, numerous studies, predominately empirical, have been undertaken by researchers in a number of jurisdictions in order to measure the costs of tax compliance and determine what factors are driving these costs.

However, due to the regressive nature of the tax compliance costs, the majority of these studies have predominately been focused on Small and Medium Enterprises (SMEs). By way of contrast, large enterprises have received very little attention in the literature mainly because large enterprises have been considered to enjoy economies of scale which significantly lessen the burden of tax compliance costs. As a result the costs of tax compliance of large enterprises has remained a largely understudied area and still little is known about the composition, magnitude and factors driving costs of compliance in large enterprises. Furthermore, the concept of a large enterprise itself remains unclear in the literature as no common definition of a large enterprise, which considers the intrinsic features of a large enterprise, has been established in prior studies.

Considering the lack of studies on large enterprises, particularly in New Zealand, the purpose of this study is to analyse how a common definition of large enterprises in New Zealand can be established and to conduct an explorative analysis of the costs of tax compliance of large enterprises in New Zealand. In addition, this study will discuss the application of a mathematical model used to describe cost efficient tax compliance administration in large enterprises.

Analysis of the common definition of large enterprises in New Zealand shows that for a more accurate definition of large enterprises, which would be defined not only by the size of their turnover but also on the basis of their intrinsic characteristics, use of qualitative criteria along with quantitative criteria can be very useful.

Applying a qualitative methodology based on explorative analysis, semi-structured interviews with selected tax practitioners and an Inland Revenue (IR) official were conducted in order to ascertain the magnitude, composition and driving factors of the compliance costs in large enterprises. The interviews were also used in order to gain an understanding of how the tax practitioners and the IR define large enterprises in New Zealand.

The findings from the interviews indicate that there is no common understanding amongst tax practitioners of what a large enterprise is in New Zealand. In addition, the IR applies the concept of “significant enterprise” instead of “large enterprise”, using this concept predominately for monitoring the tax compliance of large enterprises.

Further findings reveal that income tax is likely to be the most expensive tax to comply with for large enterprises. Complexity caused by business operations and restructuring initiated by large enterprises appears to be one of the driving factors of compliance costs. Overseas transactions and operations in foreign jurisdictions through controlled foreign companies were also found to add to the costs of tax compliance of large enterprises. Furthermore, the results indicate that large enterprises in New Zealand organise their tax compliance function in a different way to SMEs. In addition, they have a different composition of external costs of tax compliance, with more emphasis on tax planning, tax review and legal services.

Despite these limitations, the findings in this study and the analysis of the common definition of large enterprises in New Zealand can be useful for future empirical studies concerned with the estimation of the costs of tax compliance of large enterprises in New Zealand.

# Chapter 1: Introduction

## *1.1 Background to the Study*

### *1.1.1 Tax Compliance Costs: Rationale behind Research and Measurement*

Businesses, whether small or large, have to deal with a variety of regulations a government imposes on them for achieving their market and non-market policy objectives, which are aimed at protecting the broad public interest.<sup>1</sup> The United States Small Business Administration generally classifies these regulations as “economic, environmental, tax compliance, and occupational safety”.<sup>2</sup> Although the purpose of regulations is to benefit society, regulation itself ultimately generates costs - the precise estimations of which are difficult to ascertain. There exists an array of views on the issue of the “dead weight losses” emanating from these regulations depending on the perspective taken and assumptions made.<sup>3</sup> Methods used to estimate the costs of regulation also vary. Despite the difficulty in estimating the costs of regulation, there has been ongoing concern that the burden of these costs appears to be excessive for businesses, which in turn impedes economic growth and has a negative effect on the total factor of productivity. This has given strong incentive towards deregulation and simplification programs around the world.

An empirical study conducted by the Organisation for Economic Co-operation and Development (OECD)<sup>4</sup> established that a significant portion of costs (46%) incurred by businesses relate to tax compliance. The research literature has two main approaches to defining tax compliance. The first one is the legal approach, which defines tax compliance as “the willingness of individuals and other taxable entities to act in accordance within the spirit,

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<sup>1</sup> Binh Tran-Nam “Tax Compliance as a Red Tape to Business: Conceptual Issues and Empirical Evidence from Australia” (2015) 2 Journal of Business and Economic Policy 76 at 76.

<sup>2</sup> Nicole V Crain and Mark W Crain “The Impact of Regulatory Costs on Small Firms, US Small Business Administration” (Small Business Research Summary No. 371, September 2010).

<sup>3</sup> Tran-Nam, above n 1, at 76.

<sup>4</sup> OECD “Businesses’ Views on Red Tape: Administrative and Regulatory Burdens on Small- and Medium-Sized Enterprises” (Paris, 2001) at 8.

as well as the letter of tax law, and administration without the application of enforcement activity”.<sup>5</sup> Therefore, from a legal perspective tax compliance is interpreted as fulfilment of the legal obligations imposed on taxpayers by the tax legislature and accordingly tax avoidance is regarded as tax noncompliance.<sup>6</sup>

The second approach to the definition of tax compliance is the operational approach, which is seen as an alternative to the legal definition. This approach has been adopted by tax authorities and, according to Tran-Nam,<sup>7</sup> defines tax compliance as a process consisting mainly of tasks such as:

1. Registration in the system whether for tax, payroll and social insurance purposes
2. Maintaining complete and accurate information through an established system of record keeping
3. Filing the required tax information with tax authorities in due time, and
4. Timely payment of the assessed amount of tax

This operational approach emphasises administrative and procedural aspects of tax compliance where a taxpayer’s attitude towards the tax system is not viewed simply in terms of compliance or non-compliance but in terms of the wide spectrum of available actions.<sup>8</sup> It should be noted, that this current study considers tax compliance in terms of the second definition, as the focus of the study is on the costs that business taxpayers incur from dealing with tax compliance procedures.

As the literature, and research reports by various tax authorities indicate, all of these compliance tasks require considerable use of business resources, expressed in monetary terms, which in the absence of tax compliance requirements could be used more productively. Thus, according to the Business Compliance Cost Survey of 2009 commissioned by the US Internal Revenue Service (IRS), total income tax compliance costs for registered types of businesses (C

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<sup>5</sup> Simon James and Clinton Alley “Tax Compliance, Self-Assessment and Tax Administration” (1999) 2 *Journal of Finance and Management in Public Services* 27 at 32.

<sup>6</sup> Tran-Nam, above n 1, at 76.

<sup>7</sup> At 76.

<sup>8</sup> At 76.

Corporations, S Corporations, Partnerships) were estimated to be US\$110 billion (NZ\$158 billion).<sup>9</sup> Moreover, compliance by businesses with regulations and tax law can be viewed as a form of hidden taxation in addition to the tax burden itself. Therefore, a low rate of income tax and other taxes established in a particular jurisdiction does not necessarily mean that the tax regime is favourable for businesses in that jurisdiction, as at the same time the high cost of compliance with that tax regime might negate the favourable effect of a low tax rate.

From the standpoint of economic theory, costly compliance activities are no more than “dead weight losses”, in other words, pure losses for society and businesses, as they only increase the effective tax burden without increasing tax revenue.<sup>10</sup> High costs of tax compliance could distort economic decision-making creating disincentives to produce and invest. The consequences of high tax compliance costs are the diminished ability to compete in the global economy<sup>11</sup> and negative effects on the general investment climate.

In the light of the ongoing concerns that excessively high levels of tax compliance costs, referred to by Sandford<sup>12</sup> as “taxation hidden costs”, can significantly impede business productivity, economic growth and decrease the attractiveness of a country for foreign investments, many tax simplification programs have been launched around the world. Examples of such programs are the establishment of the Office of Tax Simplification in the United Kingdom (UK)<sup>13</sup> and the Rewrite Project in New Zealand.<sup>14</sup>

Strong interest towards the issue of tax compliance costs has been demonstrated by academics and other researchers who have primarily explored the theoretical aspects of tax compliance

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<sup>9</sup> George Contos and others “Taxpayer Compliance Costs for Corporations and Partnerships: A New Look” (Paper presented at the 2012 IRS-TPC Research Conference, Washington DC, 21 June 2012). Exchange rate between US\$-NZ\$ as at 15 November 2018. See the IRD “Currency rates – rolling average” <<https://www.ird.govt.nz/resources/8/d/8de01e54-60d4-49ad-9e89-dd185007c345/mid-month-nov-2018.pdf>> (last accessed 27 December 2018).

<sup>10</sup> Sebastian Eichfelder and Francois Vaillancourt “Tax Compliance Costs: A Review of Costs Burdens and Cost Structures” (Arqus Discussion Paper No. 178, 2014) at 1.

<sup>11</sup> Arthur Laffer, Wayne Winegarden and John Childs “The Economic Burden Caused by Tax Code Complexity” (Laffer Centre for Supply Side Economics, April 2011) at 7.

<sup>12</sup> Cedric Sandford (ed) *Taxation Compliance Costs: Measurement and Policy* (Fiscal Publications, Bath, 1995).

<sup>13</sup> UK Government “Office of Tax Simplification” <<https://www.gov.uk/government/organisations/office-of-tax-simplification>> (last accessed 10 January 2019).

<sup>14</sup> Adrian Sawyer “Rewriting Tax Legislation Rewriting Tax Legislation-Can Polishing Silver Really Turn It into Gold” (2013) 15 *Journal of Australian Taxation* 1.



costs and applied various methods to measure the costs of tax compliance. Many studies have been dedicated to the measurement of tax compliance costs for businesses, whether in a single jurisdiction, (for example, Australia<sup>15</sup> and New Zealand<sup>16</sup>), or among a group of jurisdictions (for example, Australia, Canada, South Africa and UK).<sup>17</sup>

However, the majority of studies, whether undertaken by academic researchers or national taxation offices, have focused on Small and Medium Enterprises (SMEs).<sup>18</sup> This is due to the regressive nature of tax compliance costs such that there has been ongoing concern that SMEs are enduring most of the tax compliance burden and thus SMEs have traditionally been at the centre of researchers' attention. In contrast to SMEs, large enterprises have been largely neglected and, as the result, presently very little is known about tax compliance costs of large enterprises in New Zealand, as well as in other countries.

Despite the focus of prior research being on SMEs, the fact that large enterprises also play a significant role in national and global economies should not be neglected. According to a report published by European Firms in a Global Economy in 2012,<sup>19</sup> large entities are found to be more productive, to pay higher wages, to enjoy higher profits and to be more successful in the international markets. Thus, taking into account the increasing role that large enterprises are playing in national economies and the existing gap in the literature, research into the tax compliance costs of large enterprises is viewed as timely and relevant.

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<sup>15</sup> Binh Tran-Nam, Chris Evans, Michael Walpole and Katrine Ritchie "Tax Compliance Costs: Research Methodology and Empirical Evidence from Australia" (2000) 52 National Tax Journal 229.

<sup>16</sup> Ranjana Gupta and Adrian Sawyer "The Costs of Compliance and Associated Benefits for Small and Medium Enterprises in New Zealand: Some Recent Findings" (2015) 30 Australian Tax Forum 135.

<sup>17</sup> John Hasseldine and others "A Comparative Analysis of Tax Compliance Costs and the Role of Special Concessions and Regimes for Small Businesses in Australia, Canada, South Africa and the United Kingdom" (Paper presented at the National Tax Association Conference, Providence, 2012).

<sup>18</sup> European Commission "A Review and Evaluation of Methodologies to Calculate Tax Compliance Costs" (Taxation Papers Working Paper N.40, 2013) at 8.

<sup>19</sup> Loris Rubini and others "Breaking down the barriers to firm growth in Europe: The fourth EFIGE policy report" (European Firms in a Global Economy, 2012) at 1.

### *1.1.2 Tax Compliance Costs: Conceptual and Measurement Issues*

As mentioned in the preceding subsections, tax compliance is viewed as a set of sequential activities performed by a business in order to comply with the legal obligations of the tax system. All of these activities come at a cost for a business, as they require time for dealing with tax regulations or researching particular parts of the tax law and making outlays on salaries for in-house accounting personnel or remunerations to external tax advisers. Incidental expenses related to the performance of tax activities, for example, the purchase of specialised tax accounting software are also incurred. These costs are known as “tax compliance costs” and are defined by Sandford, Godwin and Hardwick as: “the costs incurred by taxpayers in meeting the requirements imposed on them by the tax law and the revenue authorities”.<sup>20</sup>

There is a distinction between gross and net tax compliance costs. Gross tax compliance costs are referred to as total or social costs of compliance and net tax compliance costs are referred to those costs that are directly incurred by taxpayer.<sup>21</sup> Therefore, the first type of tax compliance costs are likely to be of interest to economists or government institutions, while the second type of costs are more likely to draw interest to businesses and revenue authorities.<sup>22</sup> Both gross and net tax compliance costs will be discussed further in Chapter 4 of this thesis.

### *1.1.3 Methods Used to Measure Tax Compliance Costs*

According to Evans and Tran-Nam,<sup>23</sup> although both qualitative and quantitative research methods have been used in studies on the measurement of business tax compliance costs, the quantitative method has prevailed in the majority of studies.

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<sup>20</sup> Cedric Sandford, Michael Godwin and Peter Hardwick *Administrative and Compliance Costs of Taxation* (Fiscal Publications, Bath, 1989).

<sup>21</sup> Binh Tran-Nam and others, above n 15.

<sup>22</sup> Chris Evans and Binh Tran-Nam “Tax Compliance Costs in New Zealand: An International Comparative Evaluation” (Tax Administration for the 21st Century Working Paper, Victoria University of Wellington, 2014) at 7.

<sup>23</sup> Chris Evans “Taxation Compliance and Administrative Costs: An Overview” in Michael Lang and others (eds) *Tax Compliance Costs for Companies in an Enlarged European Community* (Kluwer Law International, The Netherlands, 2007).

Quantitative methods require defining a representative sample of a population of business entities for which the costs of tax compliance are measured. The traditional way of collecting data has been through conducting large-scale surveys, also known as the “Sandford methodology”.<sup>24</sup> However, this method generally produces a low response rate, which in many cases is not sufficient to form a representative sample for conducting empirical analysis and for generalising results over the population of business entities. Sandford<sup>25</sup> found that the average response rate in large-scale surveys of tax compliance costs was around 30%. Tran-Nam<sup>26</sup> reports that the response rates from the large scale survey conducted among Australian business taxpayers in 2011-2012 were 7.5% for SMEs and 42% for large enterprises, respectively. A study performed by Gupta and Sawyer<sup>27</sup> on the measurement of tax compliance costs among New Zealand SMEs had a response rate of 2.7%. This is in line with findings in a number of studies showing that response rates for SMEs are considerably lower than for large enterprises.<sup>28</sup>

As an alternative to quantitative methods, researchers can employ qualitative methods in their studies of business tax compliance costs. Such methods include interviews,<sup>29</sup> expert interviews and expert assessments,<sup>30</sup> documentary analysis and diary,<sup>31</sup> and case studies.<sup>32</sup> Case studies have generally focused on tax compliance costs in a particular jurisdiction.

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<sup>24</sup> Evans and Tran-Nam, above n 22, at 13.

<sup>25</sup> Sandford, Godmin and Hardwick, above n 20, at 378.

<sup>26</sup> Tran-Nam, above n 1, at 81.

<sup>27</sup> Gupta and Sawyer, above n 16.

<sup>28</sup> Contos and others, above n 9.

<sup>29</sup> Maja Klun “Administrative Costs of Taxation in a Transition Country: The Case of Slovenia” (2003) 53 *Finance a Uver* 75; W Robert J Alexander, John D Bell and Simon Knowles “Quantifying Compliance Costs of Small Businesses in New Zealand” (University of Otago Economics Discussion Paper No. 0406, 2004).

<sup>30</sup> Robert Plamondon and David Zussman “The Compliance Costs of Canada’s Major Tax Systems and the Impact of Single Administration” (1998) 46 *Canadian Tax Journal* 761.

<sup>31</sup> Alexander, Bell and Knowles, above n 29.

<sup>32</sup> Binh Tran-Nam and John Glover “Estimating the Transitional Compliance Costs of the GST in Australia: A Case Study Approach” (2002) 17 *Australian Tax Forum* 499; Chris Evans, Binh Tran-Nam and Bev Jordan “Assessing the Potential Compliance Costs/Benefits of the Tax Value Method” (2002) 17 *Australian Tax Forum* 33.

#### *1.1.4 Overview of Empirical Findings on Tax Compliance Costs*

The first known study of tax compliance costs was performed by Haig<sup>33</sup> and since then research into tax compliance costs has progressed a long way.<sup>34</sup> There are currently a large number of empirical studies dedicated to tax compliance costs using the traditional conceptual approach to the measurement of tax compliance costs, which will be elaborated further in Chapter 4 of this thesis. Initially tax compliance costs studies focused on “foundation” countries, such as the UK, the US, Canada and Germany.<sup>35</sup> However, the research has spread to a number of other countries, including countries in Western Europe (Ireland, Netherland, Spain, Sweden and Switzerland), Australasia (Australia and New Zealand), Asia (Hong-Kong, Malaysia, Singapore and South Korea) and Africa (Ethiopia, South Africa and Tanzania).<sup>36</sup> Research into tax compliance costs has also been carried out under the sponsorship of the World Bank in a number of developing countries, such as Burundi, Kenya, Laos and Vietnam, and in several former republics of the Soviet Union, including Armenia, Georgia, Ukraine and Uzbekistan.<sup>37</sup>

Despite the use of different research methodologies and data collection strategies, according to Evans,<sup>38</sup> empirical studies have made a number of consistent and important findings.<sup>39</sup> These findings can be summarised as follows:

1. Tax compliance costs are large around the world whether in absolute monetary terms or in relation to collected tax revenue or Gross Domestic Product (GDP). Tax compliance costs range from 2% to 10% of collected tax revenue and up to 2.5% of GDP;
2. Tax compliance costs are regressive, which means that as the size of business taxpayer annual turnover becomes smaller, the burden of tax compliance costs increases. By

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<sup>33</sup> Robert Haig “The Cost to Business Concerns of Compliance with Tax Laws” (1935) 24 *Management Review* 323.

<sup>34</sup> Tran-Nam, above n 1, at 80.

<sup>35</sup> At 80.

<sup>36</sup> At 80.

<sup>37</sup> At 80.

<sup>38</sup> Evans, above n 23.

<sup>39</sup> At 457.

contrast, tax compliance costs tend to decline with the increase in the size of business turnover due to economies of scale;

3. Tax compliance costs are not declining relative to business income over time despite governments' efforts on tax simplification.

## *1.2 Research Gap*

The research gap in this study is primarily seen in the context of the three following aspects. These aspects are discussed further below in sections 1.2.1, 1.2.2 and 1.2.3. They relate to the lack of studies on tax compliance costs in large enterprises, issues with the definition of large enterprises, and finally, the role that tax compliance administration plays in reducing tax compliance costs.

### *1.2.1 Lack of Studies on Tax Compliance Costs in Large Enterprises*

As indicated in the previous subsection, the study of tax compliance costs has seen a significant development over the last 40 years. However, the focus of these studies has traditionally been on the measurement of tax compliance costs in SMEs. According to a working paper issued by the European Commission,<sup>40</sup> which contains a comprehensive review of previous studies into tax compliance costs, there have been 35 studies on SMEs and only five studies covering large enterprises.

There may be two main reasons why SMEs have received much greater attention than large enterprises in the literature:

- First, the importance of SMEs, as a source of employment growth, innovation and a tool of poverty alleviation has been recognised around the world.<sup>41</sup> According to a report by the OECD Working Party on SME's and Entrepreneurship issued in 2010,<sup>42</sup>

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<sup>40</sup> European Commission, above n 18.

<sup>41</sup> OECD "Small and Medium-sized Enterprises: Local Strength, Global Reach" (OECD Policy Brief, June 2000).

<sup>42</sup> OECD Working Party on SMEs and Entrepreneurship "Assessment of Government Support Programmes for SMEs' and Entrepreneurs' Access to Finance in the Global Crisis" ('Bologna+10' High-Level Meeting on Lessons from the Global Crisis and the Way Forward to Job Creation and Growth, Paris, 17-18 November 2010).

SMEs accounted for 99% of all business enterprises in OECD countries and constituted about two-thirds of employment .The importance of SMEs is also seen in their export and innovation capabilities and their effective exploitation of intellectual assets;<sup>43</sup>

- Second, the literature has established that tax compliance costs have a regressive nature, which implies a higher burden from tax compliance on smaller enterprises and therefore, an impediment to their growth and development. By way of contrast, large enterprises, can enjoy the benefits of economies of scale when it comes to meeting their tax obligations.<sup>44</sup>

Given these two reasons, the creation of the low tax compliance environment for SMEs has become a pivotal measure for promoting growth and innovation within the small business sector.<sup>45</sup> In turn, this has presumably prompted academic researchers to concentrate their efforts on the study and measurement of the tax compliance costs of SMEs.

In light of the fact that the literature on tax compliance costs is obviously skewed toward studying and measuring the tax compliance costs of SMEs, the issue of tax compliance costs in large enterprises remains largely understudied. This creates a significant gap in the literature, as current knowledge about the composition, size and drivers of tax compliance costs of large enterprises is limited to a handful of prior studies. The gap particularly concerns large multinational firms and their tax arrangements, as the area of tax laws and regulations applying to them is very complex and the costs and subsequent impact of this complexity have not been sufficiently analysed and measured.

Moreover, the handful of studies on large enterprises to date<sup>46</sup> indicate that in absolute value, the costs of tax compliance are indeed very high even for large enterprises, being estimated in billions of US\$ or 2.5 – 3 % of the total tax revenue collected from large enterprises in the

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<sup>43</sup> OECD Working Party on SMEs and Entrepreneurship, above n 42.

<sup>44</sup> Gupta and Sawyer, above n 16, at 137.

<sup>45</sup> New Zealand Institute of Chartered Accountants “Simplifying the Taxation of Small Business in New Zealand” (2009).

<sup>46</sup> See Joel Slemrod and Marsha Blumenthal “The Income Tax Compliance Cost of Big Business” (1996) 24 Public Finance Quarterly 411; Chris Evans, Philip Lignier and Binh Tran-Nam “Tax Compliance Costs of Large corporations: An Empirical Inquiry and Comparative Analysis”(2016) 64 Canadian Tax Journal 751.

countries where these studies were undertaken. Considering such a high magnitude of cost of tax compliance of large enterprises, further research in this area can be justified.

Furthermore, no study considering the costs of tax compliance of large enterprises in New Zealand has been undertaken (and published) in the last 20 years.<sup>47</sup> Accordingly, conducting a study with a focus on New Zealand large enterprises would be a valuable contribution to the literature.

### *1.2.2 Issues with the Definition of Large Enterprises*

One of the most problematic aspects pertaining to large enterprises is how they should be defined. Although the term “large enterprise” is extensively used throughout this thesis as a key concept, it has not been defined conclusively or, at least given some clarification as to its meaning. Previous studies in the area of tax compliance costs have not given this aspect proper consideration, preferring to use official definitions, whether provided by tax authorities or statistical bureaus. Reliance on official sources for establishing what enterprise to consider as large appears to be an easy way to draw an imaginary line separating a class of large enterprises from SMEs.

Due to the existence of an array of official criteria, even within a single jurisdiction, to classify large enterprises, the problem arises as to what definition to choose. For example, in the case of New Zealand, classifying an enterprise as a large depends on what definition one uses as a benchmark. The New Zealand Ministry of Business, Innovation and Employment (MBIE) considers an entity with over 100 employees<sup>48</sup> as large, whereas an entity with an annual turnover of more than NZ\$30 million or assets valued at over NZ\$60 million would be considered as large in terms of the criteria established in the New Zealand Financial Reporting Act 2013 (FRA 2013).<sup>49</sup> The New Zealand Inland Revenue (IR) no longer officially applies the term “large enterprise” for the tax compliance purposes. Instead it uses “significant

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<sup>47</sup> The last known in the literature study on large enterprises in New Zealand was conducted by John Prebble in 1995. It was a qualitative study, which estimated costs incurred by large enterprises in New Zealand to comply with the CFCs regime. See John Prebble “Costs of compliance with the New Zealand controlled foreign company regime” in Cedric Sandford (ed) *Tax Compliance Costs Measurement and Policy* (Fiscal Publications, Bath, 1995).

<sup>48</sup> MBIE “The small business sector report” (2014).

<sup>49</sup> FAR 2013, s 45(1)(a).

enterprise” for its core compliance purposes. The category of significant enterprises includes enterprises with an annual turnover starting from NZ\$30 million. However, among “significant enterprises”, the IR concurrently considers enterprises with an annual turnover greater than NZ\$80 million to be large.<sup>50</sup>

The availability of various official definitions, where each definition is adopted in accordance with economic, financial reporting or tax administration purposes, means that the same business entity can be simultaneously included in either the large or SME category, depending on which definition from the above three categories is used. The following statistics further illustrate this issue. According to the MBIE (which uses the number of employees to classify an entity’s size), large enterprises in New Zealand account for 0.4% of the total number of business entities.<sup>51</sup> However, statistics provided by the IR, which uses annual turnover as its main criterion, provides a different percentage of the large enterprises in New Zealand (0.2% of all registered entities).<sup>52</sup> Consequently, the estimation of the magnitude of the costs of tax compliance for the whole population of large enterprises in New Zealand might be affected by the choice of particular official definition, as the size of the population of large enterprises itself may fluctuate between 0.2% and 0.4%.

As each of the definitions presented above interprets large enterprises in a different way, then the question arises: is it possible to come up with a single definition, which would reflect not only numerical criteria like turnover or assets value, but also the intrinsic characteristics of large entity? Large enterprises, due to the large scale of their businesses, typically: possess a complex organisational structure, feature a group of separate entities, have a diverse capital structure and operate internationally. In addition, large enterprises are present in those sectors of economy where large capital outlays are required: finance, insurance, resource exploration and energy sectors. All these factors indicate that in order to define large enterprise its intrinsic

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<sup>50</sup> More information on how the IR defines significant enterprises is provided in Chapter 6 of this thesis.

<sup>51</sup> Statistics New Zealand “Business demography statistics”  
<[http://nzdotstat.stats.govt.nz/wbos/Index.aspx?DataSetCode=TABLECODE7604&\\_ga=2.263378116.975941172.1545634605-2096137522.1543898237#](http://nzdotstat.stats.govt.nz/wbos/Index.aspx?DataSetCode=TABLECODE7604&_ga=2.263378116.975941172.1545634605-2096137522.1543898237#)> (last accessed 26 December 2018).

<sup>52</sup> IR “Registered customers by groups 2008-2017” <<https://www.ird.govt.nz/aboutir/external-stats/customers/reg-by-customer-group/customers-reg-cust-by-groups.html>> (last accessed 23 December 2018).



features should be considered along with numerical criteria represented by turnover, value of assets and number of employees.

### *1.2.3 Cost Efficient Tax Compliance Administration and Tax Compliance Costs*

Empirical estimations of the costs of tax compliance made in previous studies, including studies focused on large enterprises, have never considered the role that tax compliance administration plays in reducing costs of tax compliance. Tax compliance administration implies a set of various methods that a business taxpayer can use in order to deal with tax compliance obligation. Therefore, if a cost efficient method is chosen then the costs of tax compliance can be minimised through the use of this method. Previous studies of the costs of tax compliance operate only with those costs that could be observed in practice and therefore the effect of cost inefficient tax compliance administration has never been captured in the literature, as inefficiency costs cannot be observed. This applies to studies of the costs of tax compliance in both SMEs and large enterprises.

By failing to measure inefficiency costs, the basis of the previous studies' estimations of the costs of tax compliance means it is not possible to determine how much of the costs can be attributed to the complexity of tax system and how much are due to the cost inefficient tax compliance administration. Therefore, measurement of inefficiency costs can assist in a more accurate estimation of the costs of tax compliance and provide more insights into the level of efficiency of business taxpayers in terms of carrying out their tax compliance functions. These insights can be especially useful for large enterprises as they generally have more resources available for choosing various tax compliance strategies.

Economics, especially neoclassical economics, has a theory based on which a model of cost efficient tax compliance administration can be built. The theory and the model are discussed in more detail in the conceptual frameworks outlined in Chapter 5 of this thesis. Although, it is not a purpose of this study to empirically estimate the cost of tax compliance of large enterprises in New Zealand, the findings of the model can nevertheless provide insights into the cost efficient tax compliance administration in large enterprises and serve as a useful tool in the methodology of the study.

### *1.3 Identification of the Objectives of the Study and Research Questions*

In accordance with the research gap outlined above, this study intends to contribute to the literature by raising the discussion on the concept of a large enterprise. Further, motivated by the lack of studies considering large enterprises in New Zealand, this study aims to provide an exploratory analysis of the aspects related to the costs of tax compliance of large enterprises in New Zealand.

Therefore, the first objective is to analyse what criteria can be used in order to define a large enterprise in New Zealand. These criteria are important for understanding the concept of large enterprises and also for determining the population of large enterprises in New Zealand. Prior to starting to measure the magnitude of the costs of tax compliance, it is essential to know what we are measuring. The definition of large enterprises should help to draw a line separating SMEs from large enterprises in New Zealand, a line which seems to be blurred at the moment. Besides, establishing the definition of large enterprises in New Zealand would allow a comparison with prior studies, undertaken in other jurisdictions, to be made in regard to the magnitude and composition of the costs of tax compliance.

The second objective is to ascertain the magnitude, composition and the drivers of the tax compliance costs of large enterprises in New Zealand using information provided by external tax practitioners and tax managers of large enterprises. This information is considered useful as it is anticipated to provide insight into what types of taxes are the most costly for large enterprises in New Zealand to comply with, what areas of taxation are viewed by large enterprises as the most complex and what are the main drivers of cost of tax compliance of large enterprises. The insights obtained are anticipated to form the basis for policy recommendations. It is also anticipated that the feedback received from the participants will also provide insights into whether large enterprises in New Zealand follow a cost efficient tax compliance strategy.

The third objective is to analyse the differences between SMEs and large enterprises in New Zealand in terms of how they carry out their tax compliance functions and in terms of the composition of the costs of tax compliance. This analysis is considered to be useful in providing insights into how tax compliance functions and how the composition of the costs of tax compliance change as the size of an enterprise increases. A deeper understanding of these

differences should provide more insights into the drivers and composition of the cost of tax compliance of large enterprises.

The objectives of the study are addressed through the following research questions:

*RQ1. How can we define a “large enterprise” in New Zealand, if we want to study and measure its tax compliance costs?*

*RQ2. What are the magnitude, composition and drivers of tax compliance costs in large enterprises in New Zealand?*

*RQ3. How do large enterprises differ from SMEs in terms of the tax compliance activities and composition of tax compliance costs?*

#### *1.4 Significance of the Study*

First, this study contributes to the literature by bridging the gap in the tax compliance costs literature on the small number of studies featuring large enterprises. Despite the well-established view that large enterprises benefit from “economies of scale” and, therefore in comparison to SMEs, are presumed to bear less tax compliance costs relative to the size of their turnover, previous studies conducted in the US<sup>53</sup> and Australia<sup>54</sup> indicate that in absolute terms these costs are expected to be quite significant. Furthermore, by focusing on New Zealand large enterprises, this study is considered to be the first attempt to analyse the aspects of the tax compliance costs and their driving factors among large enterprises in New Zealand. Therefore, this study contributes towards a better understanding of the magnitude, composition and factors driving costs of tax compliance in large enterprises in New Zealand.

Second, this study can benefit future empirical research by providing criteria for the definition of large enterprises in New Zealand. Establishing criteria, which assist in identifying large enterprises on the basis of their intrinsic characteristics, is considered a useful contribution for determining the population of large enterprises in New Zealand. When conducting an empirical

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<sup>53</sup> Joel Slemrod and Marsha Blumenthal “The Income Tax Compliance Cost of Big Business” (1996) 24 Public Finance Quarterly 411.

<sup>54</sup> Chris Evans, Philip Lignier and Binh Tran-Nam “Tax Compliance Costs of Large corporations: An Empirical Inquiry and Comparative Analysis” (2016) 64 Canadian Tax Journal 751.

study of the costs of tax compliance of large enterprises in New Zealand, determination of the population of large enterprises is critically important.

Third, through exploring the idea that the costs of tax compliance in large enterprises can be affected by the efficiency of the tax compliance administration (which primarily depends on the way in which large enterprises choose and allocate the resources available to them for meeting tax compliance obligations), this study contributes in two ways. First, it provides insights into whether large enterprises in New Zealand follow cost efficient tax compliance administration. Second, it lays the foundation for future empirical studies on the effect of cost optimisation on the costs of tax compliance in large enterprises.

### *1.5 Structure of the Thesis*

This chapter has set out the background to the topic, identified a gap in the literature, outlined the research questions and objectives, and finally explained why the research topic is important. The remainder of this thesis is organised as follows.

Chapter 2 will present a review of the literature on earlier studies into the tax compliance costs of large enterprises conducted in different countries. Special emphasis is given to the discussion of the methodology which is applied in each study and the main findings regarding the composition and drivers of tax compliance costs in large enterprises in each of the countries where the studies were undertaken. Attention is also given to the limitations of these studies.

Chapter 3 will be dedicated to an analysis of the concept of a large enterprise. Specifically it discusses what entity may be considered a large enterprise in New Zealand. Along with discussion of quantitative criteria and thresholds, several qualitative criteria, describing large enterprises on the basis of their intrinsic features, will be outlined and analysed for their appropriateness for classifying large enterprises.

Chapter 4 will outline the tax compliance obligations that large enterprises face in New Zealand. This chapter will also provide information on the tax compliance of multinational enterprises, especially “large multinational groups of enterprises”. This information is considered important as the compliance of these enterprises is strongly affected by the recently adopted Base Erosion and Profit Shifting (BEPS) initiatives in New Zealand (which will also be elaborated upon in this chapter).

Chapter 5 will present and discuss in more detail the conceptual framework for measurement of the costs of tax compliance and the methodology of the research. As part of the conceptual framework, a brief overview of the rational choice theory will be provided followed by the presentation of the model of cost efficient tax compliance administration. As this research is primarily qualitative in nature, the essence of explorative analysis (adopted as the methodology for this study) will be elaborated upon. This will be followed by a description of the research method (semi-structured interviews) employed in this study for the collection of data.

Chapter 6 will present the results gathered from the semi-structured interviews conducted with external tax practitioners and an IR official. The feedback provided by external tax practitioners regarding the magnitude, composition and drivers of the cost of tax compliance in large enterprises in New Zealand will also be discussed along with the implications of their feedback. The interview with the IR official will provide insights into the definition of large enterprises in New Zealand used by the IR for monitoring tax compliance purposes.

Finally, Chapter 7 will provide an overview of main findings of this study and discuss the contribution that this study makes to the field of tax compliance costs in large enterprises. The limitations of the study, policy implications and suggestions for future research will also be presented.

## Chapter 2: Literature Review

In the previous chapter a brief introduction to the area of tax compliance and the costs associated with tax compliance was presented. The principal aim of this chapter is to provide a review of the literature on tax compliance costs in Small and Medium Enterprises (SMEs) and large enterprises. This chapter is organised as follows. An overview of the history of studies of the tax compliance costs is provided in section 2.1. Next, section 2.2 discusses the scope of prior studies in order to provide insights into what aspects of tax compliance costs were considered in prior studies and which entities these studies focused on. Section 2.3 briefly outlines studies measuring costs of tax compliance in SMEs, while section 2.4 is dedicated to a detailed review of studies focusing on tax compliance in large enterprises. Finally, section 2.5 summarises main findings from the studies on large enterprises.

### *2.1 Historical Context of Tax Compliance Costs Studies*

The idea that a tax system generates operating costs goes back to the times of Adam Smith, who developed the modern principle of tax simplicity which recognises the impact of tax operation costs on the tax system.<sup>1</sup> However, the study into the costs of tax compliance, especially their assessment and measurement, did not start until the beginning of the 20th century<sup>2</sup> partly because tax compliance costs have been considered as “hidden costs” of taxation and therefore insignificant. The first published attempt to measure tax compliance costs was made by Haig<sup>3</sup> in 1935 who used postal survey of 1,500 large United States (US) firms to estimate their tax compliance costs.<sup>4</sup> After Haig’s study there were a few more attempts among academics to estimate administrative costs of taxation. Most of these studies were conducted in US.

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<sup>1</sup> Chris Evans “Studying the Studies: An overview of recent research into taxation operating costs” (2003) 1 eJournal of Tax Research 64.

<sup>2</sup> Evans, above n 1.

<sup>3</sup> Robert Haig “The Cost to Business Concerns of Compliance with Tax Laws” (1935) 24 Management Review 323

<sup>4</sup> Evans, above n 1.

A renaissance in the studies on tax compliance costs began in 1970 following the early studies by Sandford <sup>5</sup> and Sandford, Godwin, Hardwick and Butterworth. <sup>6</sup> In the period from 1970 to 1993, there were 41 separate studies on compliance costs,<sup>7</sup> carried out in different countries and employing a variety of methods, including surveys, case studies and interviews. Starting from the early 1990s the literature on tax compliance costs has experienced another wave of growing interest, accompanied by an increased awareness of the issue of tax system operating costs by governments of many countries.<sup>8</sup> Sandford <sup>9</sup> explained the reason for such a noticeable growth in studies of tax compliance costs due to the presence of the following factors:

- significant changes in computer technologies allowing researchers to conduct large scale surveys and improve the quality of their data;
- introduction of value added tax in many countries which involved significant growth in recording activities resulting in increased costs of tax compliance associated with this tax;
- growth of the small business sector and its importance in the economy. Tax compliance costs were found to be particularly burdensome for small businesses; and
- increased complexity of the tax system and the increased emphasis of government on voluntary tax compliance.

While in the 1980s the focus of studies was mainly on Canada, the United Kingdom (UK), the US and Ireland,<sup>10</sup> in the 1990s and 2000s the geographical area of studies in tax compliance costs expanded into the countries of Africa, Australasia (including New Zealand) and South America. Increased interest towards studying costs of tax compliance among developing countries can be explained partly by the intensification of competition for foreign direct investment.<sup>11</sup> Among the examples of studies performed during this period are studies of tax

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<sup>5</sup> Cedric Sandford *Hidden Costs of Taxation* (Institute for Fiscal Studies, London, 1973).

<sup>6</sup> Cedric Sandford and others *Costs and Benefits of VAT* (Heinemann, London, 1981).

<sup>7</sup> Evans, above n 1.

<sup>8</sup> Above Evans, above n 1.

<sup>9</sup> Sandford, above n 4.

<sup>10</sup> European Commission “A Review and Evaluation of Methodologies to Calculate Tax Compliance Costs” (Taxation Papers Working Paper N.40, 2013).

<sup>11</sup> Binh Tran-Nam and others “Tax Compliance Costs: Research Methodology and Empirical Evidence from Australia” (2000) 53 National Tax Journal 229.

compliance costs in Tanzania<sup>12</sup>, Hong Kong<sup>13</sup> and India.<sup>14</sup> More recent studies conducted include those conducted in South Africa<sup>15</sup> and Indonesia.<sup>16</sup>

## 2.2 Scope of Prior Studies

As Evans<sup>17</sup> mentions, and the 2013 report of the European Commission<sup>18</sup> confirms, the focus of the majority of studies on tax compliance costs has been on business taxpayers rather than on individuals. Studies on tax compliance costs measurement can generally be divided into two main groups:

- Studies that focus on measurement of costs of a particular tax. According to a review of the literature by the European Commission<sup>19</sup> the number of studies that measure tax compliance costs of particular taxes include: Value Added Tax (VAT) (16 studies); GST (five studies) and corporate income tax (seven studies). Examples include studies of UK VAT by Sandford, Godwin and Hardwick,<sup>20</sup> Hasseldine and Hansford.<sup>21</sup>

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<sup>12</sup> Christine Shekidele “Measuring the Compliance Costs of Taxation Excise Duties 1995-96” (1999) 7 African Journal of Finance and Management 72.

<sup>13</sup> Samuel Chan and others “Compliance Costs of Corporate Taxation in Hong Kong” (1999) 25 International Tax Journal 42.

<sup>14</sup> Saumen Chattopadhyay and Arindan Das-Gupta “The Compliance Costs of the Personal Income Tax and its Determinants” (National Institute of Public Finance and Policy, New Delhi, 2002).

<sup>15</sup> Hasseldine John and others “A Comparative Analysis of Tax Compliance Costs and the Role of Special Concessions and Regimes for Small Businesses in Australia, Canada, South Africa and the United Kingdom” (Paper presented to the National Tax Association Conference, Providence, 2012).

<sup>16</sup> Budi Susila and Jeff Pope “The Tax Compliance Costs of Large Corporate Taxpayer in Indonesia” (2012) 27 Australian Tax Forum 719.

<sup>17</sup> Evans, above n 1.

<sup>18</sup> European Commission, above n 10, at 8.

<sup>19</sup> European Commission, above n 10, at 6.

<sup>20</sup> Cedric Sandford, Michael Godwin and Paul Hardwick *Administrative and Compliance Costs of Taxation* (Fiscal Publications, Bath, 1989).

<sup>21</sup> John Hasseldine and Ann Hansford “The Compliance Burden of the VAT: Further Evidence from the UK” (2002) 17 Australian Tax Forum 369.



Examples of studies on corporate income tax include companies' income tax in Australia<sup>22</sup> and corporate income tax in Singapore;<sup>23</sup>

- Studies that cover compliance costs of variety of taxes or of a whole tax system. The number of such studies according to the 2013 European Commission report<sup>24</sup> is 63.

Further, most of the studies do not measure tax compliance costs separately for large and small entities or by the segment in which an entity operates, but rather include both large and small businesses from all segments in their analysis.<sup>25</sup> However, there are a number of studies focusing specifically on either the tax compliance costs of SMEs or on the tax compliance costs of large enterprises. Examples of studies where tax compliance costs are measured for large enterprises are Slemrod and Blumenthal,<sup>26</sup> Chan, Ariff and Loh,<sup>27</sup> Susila and Pope<sup>28</sup> and Evans, Lignier and Tran-Nam.<sup>29</sup> Studies on SMEs include Wallschutzsky and Gibson,<sup>30</sup> Tran-Nam and Glover,<sup>31</sup> and Gupta and Sawyer.<sup>32</sup> The European Commission's report<sup>33</sup> on the review of the tax compliance costs literature mentions that large enterprises are represented by

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<sup>22</sup> Jeff Pope, Ronald Fayle and Dong-Ling Chen "The Compliance Costs of Public Companies' Income Taxation in Australia" (Australian Tax Research Foundation, Sydney, 1991).

<sup>23</sup> Mohhamed Ariff, Zubaidah Ismail and Alfred Loh "Compliance Costs of Corporate Income Tax in Singapore" (1997) 24 *Journal of Business Finance & Accounting* 1253.

<sup>24</sup> European Commission, above n 10, at 6.

<sup>25</sup> Evans, above n 1.

<sup>26</sup> Joel Slemrod and Marsha Blumenthal "The Income Tax Compliance Cost of Big Business" (1996) 24 *Public Finance Quarterly* 411.

<sup>27</sup> Samuel Chan, Mohhamed Ariff and Alfred Loh "Compliance Costs of Corporate Taxation in Hong Kong" (1999) 25 *International Tax Journal* 42.

<sup>28</sup> Susila and Pope, above n 16.

<sup>29</sup> Chris Evans, Philip Lignier and Binh Tran-Nam "Tax Compliance Costs of Large corporations: An Empirical Inquiry and Comparative Analysis" (2016) 64 *Canadian Tax Journal* 751.

<sup>30</sup> Ian Wallschutzky and Brian Gibson "Small Business Cost of Compliance" (1993) 10 *Australian Tax Forum* 527.

<sup>31</sup> Binh Tran-Nam and John Glover "Estimating the Transitional Compliance Costs of the GST in Australia: A Case Study Approach" (2002) 17 *Australian Tax Forum* 499.

<sup>32</sup> Ranjana Gupta and Adrian Sawyer "The Costs of Compliance and Associated Benefits for Small and Medium Enterprises in New Zealand: Some Recent Findings" (2015) 30 *Australian Tax Forum* 135.

<sup>33</sup> European Commission, above n 10, at 8.

only five studies, while SMEs are represented by 35 studies. Evans<sup>34</sup> counts the number of studies that deals specifically with large enterprises to be eight. Notwithstanding this minor difference in the count of the number of studies on large enterprises between Evans and the European Commission Report, it is obvious that large enterprises are noticeably underrepresented in the literature in relation to existing studies on SMEs. The methods and results of the studies looking at tax compliance costs of SMEs and large enterprises will be presented in more detail further in this section.

### *2.3 Tax Compliance Costs of Small and Medium Enterprises*

Although, the focus of this study is on large enterprises, presenting the results of prior studies which measure costs of tax compliance of SMEs is nevertheless considered relevant as it demonstrates the type of data and data collection methods which were applied and the tax compliance activities that were examined.

Among the early studies attempting to measure the tax compliance costs of SMEs is the study by Sandford and others<sup>35</sup> conducted in the UK. The majority of data used in their study was collected through four different surveys, tailored for businesses of different sizes, in order to measure the costs of tax compliance activities associated with VAT, pay as you earn tax (PAYE) and company tax. The results of the study showed that for small businesses with turnover of less than £100,000,<sup>36</sup> tax compliance costs were approximately 3.66% of turnover. In contrast, tax compliance costs incurred by large business with turnover over £1 million<sup>37</sup> were estimated to be 0.17% of the turnover volume.

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<sup>34</sup> Evans, above n 1.

<sup>35</sup> Sandford and others, above n 6.

<sup>36</sup> As the UK GDP deflator increased by 254% from 1981 to 2018, this equates to £255,000 in 2018. See Trading Economics “UK GDP Deflator” <<https://tradingeconomics.com/united-kingdom/gdp-deflator>> (last accessed 15 July 2018). This is equivalent to NZ\$ 492,000 as at 15 November 2018. See the IRD “Currency rates – rolling average” <<https://www.ird.govt.nz/resources/8/d/8de01e54-60d4-49ad-9e89-dd185007c345/mid-month-nov-2018.pdf>> (last accessed 26 December 2018).

<sup>37</sup> £2.5 million (NZ\$ 4.83 million) in 2018. See Trading Economics, above n 36 for the UK GDP deflator and IRD, above n 36 for the NZ\$ exchange rate.

Another example of an earlier study of business tax compliance costs is the study performed by Sandford and Hasseldine,<sup>38</sup> which was the first comprehensive study to be conducted in the New Zealand context. With respect to collecting the data on tax compliance, two separate surveys were used by the authors. One of the surveys was intended for gathering data on costs to comply with PAYE and Fringe Benefit Tax (FBT), while the other survey related to Goods and Services Tax (GST) and business income tax. The results revealed that total tax compliance costs were estimated to be NZ\$1,182 million,<sup>39</sup> which comprised the monetary value of 46.6 million hours of time spent on compliance with all four types of taxes examined, and NZ\$600 million<sup>40</sup> of outlays on external advisers' fees and various other expenses. Also, the study estimated that in regard to small businesses with the turnover less than NZ\$30,000, overall tax compliance costs were equivalent to 3.14% of small firms' turnovers. For large businesses with turnover over NZ\$50 million, the ratio of tax compliance costs to firm's turnover was found to be 0.03%. Thus, the empirical results obtained in Sandford and Hasseldine<sup>41</sup> confirmed the regressive nature of tax compliance costs both for each tax individually and for all taxes collectively.

In 2004 Colmar Brunton<sup>42</sup> measured the compliance burden of SMEs in New Zealand using a mail-out survey with a 44% response rate. In addition to the main survey, a smaller survey was conducted amongst tax advisers in order to apportion external tax adviser's compliance costs to the different types of taxes. The study found that the average annual number of hours that SMEs spent on tax compliance activities was 76.7 hours, with GST taking up the largest amount of this time followed by business income tax, PAYE and FBT. The average total tax compliance costs (internal and external costs combined) was NZ\$4,024.<sup>43</sup> The ratio of the tax compliance costs to annual turnover was 21% for the smallest business (with turnover less than

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<sup>38</sup> Cedric Sandford and John Hasseldine "The Compliance Costs of Business Taxes in New Zealand" (Institute of Policy Studies, Wellington, 1992).

<sup>39</sup> As the New Zealand GDP deflator increased by 70% from 1992 to 2018, this equates to NZ\$ 2 billion in 2018. See Trading Economics "New Zealand GDP Deflator" <<https://tradingeconomics.com/new-zealand/gdp-deflator>> (last accessed 26 December 2018).

<sup>40</sup> NZ\$1.02 billion in 2018. See Trading Economics, above n 39 for the New Zealand GDP deflator.

<sup>41</sup> Sandford and Hasseldine, above n 38.

<sup>42</sup> Colmar Brunton "Measuring the Tax Compliance Costs of Small and Medium Sized Businesses—A Benchmark Survey: Final Report" (2005).

<sup>43</sup> As New Zealand GDP deflator increased by 42% from 2004 to 2018, this equates to NZ\$ 5,633 in 2018. See Trading Economics, above n 39.

NZ\$20,000) and 0.2% for the largest business (with turnover up to NZ\$ 1.3 million). This study again confirmed the fact that tax compliance costs are regressive.

Gupta and Sawyer<sup>44</sup> is the most recent study of the costs of tax compliance of New Zealand SMEs. The authors used an online survey administered among 4,400 New Zealand SMEs and the response rate they achieved was 2.7% (118 valid responses). One of the features of this study was an attempt to separate core accounting activities from tax compliance activities in order to measure tax compliance costs more precisely. The study also sought to find out if there were managerial benefits for New Zealand SMEs arising from tax compliance activities. The tax compliance costs estimation indicated that the gross costs of complying with all taxes were NZ\$31,744<sup>45</sup> for the 2011-2012 year. The study established that compliance activities connected with GST accounted for the largest portion of internal tax compliance costs for SMEs (more than 50%), followed by income tax, PAYE, FBT and KiwiSaver. In regard to managerial benefits from tax compliance, it was found that a majority of SMEs saw significant managerial benefits in tax compliance, as improved record keeping assisted them in better understanding and controlling their financial affairs.

## *2.4 Tax Compliance Costs of Large Enterprises*

A few studies that specifically targeted large enterprises have been already been introduced in this chapter. This section will provide a more detailed analysis of the findings of these studies.

To date, the research that focuses specifically on the tax compliance costs of large businesses has been carried out on very few occasions, with the majority of studies undertaken in the 1990s.<sup>46</sup> Among the studies which were conducted in the 1990s, the studies by Slemrod and

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<sup>44</sup> Gupta and Sawyer, above n 32.

<sup>45</sup> As values in the study are quoted originally in Australian dollars, this New Zealand dollar amount has been obtained using the conversion rate between AU\$ and NZ\$ as at 31 December 2012. As the NZ GDP deflator increased by 12% from 2012 to 2018, this equates to NZ\$ 35,553 in 2018. See Trading Economics, above n 39.

<sup>46</sup> Budi Susila and Jeff Pope "Why the Tax Compliance Costs of Large Companies in Indonesia are Low Compared to the Other Countries: Empirical Evidence" (2014) Australian Tax Forum 60 at 63.

Blumenthal,<sup>47</sup> and Erard,<sup>48</sup> were undertaken in the North America, namely US and Canada. Other research conducted in the 1990s which considers the tax compliance costs of large enterprises, is the study by Chan, Ariff and Loh.<sup>49</sup> This study focused on publicly listed companies in Hong Kong.<sup>50</sup> Interestingly, in the new millennium, only two studies have been undertaken to date. Susila and Pope<sup>51</sup> examine tax compliance costs of large enterprises in Indonesia and Evans, Lignier and Tran-Nam<sup>52</sup> measure the costs of tax compliance among large enterprises in Australia. The findings in each of these studies will be discussed below.

#### *2.4.1 Studies Conducted in the 1990s*

##### *2.4.1.1 US Large Enterprises*

Slemrod and Blumenthal<sup>53</sup> undertook a mail survey among 1,329 of the largest corporations in the US with a response rate of 27.5% (equivalent to 365 completed surveys). The “smallest” large entity in the population of surveyed large corporations (defined in terms of employee number and sales volume) was one with 2,500 employees and with US\$268 million (NZ\$ 412 million)<sup>54</sup> of annual sales volume. The survey results revealed that large entities in the US spent on average US\$1.57 million<sup>55</sup> per year to comply with Federal and State corporate income

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<sup>47</sup> Slemrod and Blumenthal, above n 26.

<sup>48</sup> Brian Erard “The Income Tax Compliance Burden on Canadian Big Business” (Working Paper 97-2 prepared for the Technical Committee on Business Taxation, 1997).

<sup>49</sup> Chan, Ariff and Loh, above n 27.

<sup>50</sup> Although current official name of Hong Kong is Hong Kong Special Administrative Region of the People's Republic of China (Hong Kong SAR), the study uses data for the period of 1995-1996, which is before the time when Hong Kong was transferred to China.

<sup>51</sup> Susila and Pope, above n 16.

<sup>52</sup> Evans, Lignier and Tran-Nam, above n 29.

<sup>53</sup> Slemrod and Blumenthal, above n 26.

<sup>54</sup> US\$ - NZ\$ 1995 average exchange rate (1US\$= NZ\$1.53). Reserve Bank of New Zealand “Exchange Rates and TWI –B1” <<https://www.rbnz.govt.nz/statistics/b1>> (last accessed 26 December 2018).

<sup>55</sup> As the US GDP deflator increased by 49% from 1995 to 2018, this equates to US \$ 2.35 million in 2018. See Trading Economics “US GDP Deflator” <<https://tradingeconomics.com/united-states/gdp-deflator>> (last accessed 27 December 2018). This is equivalent to NZ\$3.38 million as at 15 November 2018. See IRD “Currency rates–rolling average” <<https://www.ird.govt.nz/resources/8/d/8de01e54-60d4-49ad-9e89-dd185007c345/mid-month-nov-2018.pdf>> (last accessed 27 December 2018).

taxes. This translates to US\$2.080 billion<sup>56</sup> of total tax compliance costs for the population of the 1,329 largest US corporations. This amount of tax compliance costs for the largest entities in the US constituted approximately 2.6% of the total tax revenue that the Internal Revenue Service (IRS) collected from these large enterprises at that time.

The results also showed that about 80% of compliance costs are spent on in-house activities and 20% on external advisers. Among in-house compliance costs almost 30% were non-personnel costs. Among the in-house personnel share of tax compliance costs, 70% of the costs were incurred by tax department personnel, with the remainder coming from non-tax departments.

The breakdown of the cost associated with record keeping, tax research, tax filing, tax planning, audit, appeals and litigation shows that almost 50% of costs are related to basic compliance (record keeping and tax filing), while 35% of the costs are expended on tax planning, audit and litigation.

Furthermore, the results demonstrate a clear division of compliance activities between in-house personnel and external tax advisers. Almost 90% of costs related to record keeping and tax filing are generated internally, while almost 40% of tax planning, audit and litigation costs are produced by the services from external tax advisers.

The study further analysed the effect on the magnitude of tax compliance costs of factors such as the large entity's size, the sector within which it operates and whether it has a multinational presence. It was established that a 10% increase in firm's size (expressed either by the value of assets or sales) leads to increase in tax compliance costs between 4.1% and 6.1%, thus again confirming the effect of economies of scale for large enterprises. The fact that tax compliance costs tend to increase in magnitude with the firm's size is one of the main findings in this study.

The sector effect showed that depending on the type of sector within which a large enterprise operates tax compliance costs can be higher or lower. For example, for enterprises operating in the mining, oil or gas sectors, tax compliance costs were on average 71% higher compared to enterprises which do not operate in these sectors. Similarly, enterprises in wholesale or retail

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<sup>56</sup> US\$3.12 billion (NZ\$4.49 billion) in 2018. See Trading Economics, above n 55, for US GDP deflator and IRD, above n 55, for the US\$-NZ\$ exchange rate.

industries experience tax compliance costs which were 61% lower relative to enterprises from other sectors.

The factor of enterprise worldwide presence (measured by the percentage of worldwide employees, worldwide assets value or worldwide sales) also adds to an increase in tax compliance costs although the impact is less than proportionate.

#### *2.4.1.2 Canadian Large Enterprises*

Erard's<sup>57</sup> study was focused on large enterprises in Canada and it closely followed the study by Slemrod and Blumenthal<sup>58</sup> in the method employed. The survey was mailed to all 250 members of the Canadian Tax Executive Institute, most of whom ranked among the very largest corporations in Canada at that time. The number of responses received was 59, which is equivalent to a 24% response rate. Fourteen large enterprises out of the 59 respondents were operating in the financial sector. The average size of large enterprises from both the non-financial and financial sectors was measured by number of employees, gross receipts and total value of assets. Thus, on average, large enterprises from the non-financial sector had 8,568 employees, CA\$2.88 billion (NZ\$3.24 billion)<sup>59</sup> of gross receipts and assets worth CA\$3.45 billion (NZ\$3.87 billion)<sup>60</sup> of book value. The average number of employees for the large enterprises from the financial sector was 13,041, average gross receipts and average book value of assets were CA\$5.25 billion (NZ\$5.9 billion) and CA\$58.4 billion (NZ\$65.6 billion)<sup>61</sup>, respectively.

The results of the study revealed that, on average, the costs of tax compliance incurred by large enterprises in the non-financial sector was CA\$507,000,<sup>62</sup> implying that the aggregate amount

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<sup>57</sup> Erard, above n 48.

<sup>58</sup> Slemrod and Blumenthal, above n 26.

<sup>59</sup> CA\$ - NZ\$ 1995 average exchange rate (1CA\$=NZ\$1.125). Reserve Bank of New Zealand "Exchange Rates and TWI – B1" <<https://www.rbnz.govt.nz/statistics/b1>> (last accessed 26 December 2018).

<sup>60</sup> See above n 59.

<sup>61</sup> See above n 59.

<sup>62</sup> As the Canada GDP deflator increased by 41% from 1995 to 2018, this equates to CA\$715,000 in 2018. See Trading Economics "Canada GDP Deflator" <<https://tradingeconomics.com/canada/gdp-deflator>> (last accessed 26 December 2018). This is equivalent to NZ\$797,000 as at 15 November 2018. See IRD "Currency rates – rolling

of tax compliance costs for the whole group of non-financial large enterprises (the 500 top largest non-financial enterprises) was around CA\$250 million.<sup>63</sup> Average tax compliance costs turned out to be even higher if large financial enterprises were included in the estimation. Thus, the average tax compliance costs were CA\$925,000<sup>64</sup> after including large enterprises from financial sector in the estimation. In relation to the total tax revenue collected from the top non-financial large enterprises, the results of the study suggested a compliance burden of almost 5% of taxes paid. The ratio of tax compliance burden, including financial firms, to the amount of taxes paid was 2.7%.

The composition of tax compliance costs showed that in-house personnel accounted for 56.9% of the total costs, in-house non-personnel expenditures and assistance of external experts accounted for 20.6% and 22.5 %, respectively. Furthermore, the breakdown of the costs structure revealed that about 46% of the total internal costs were spent on record keeping and filing returns, while only 9.5% of the total external costs related to record keeping and filing. Among external costs, 53% and 37% were associated with tax planning and audit, and appeals and litigation respectively.

As for the determinants of the tax compliance costs of the largest Canadian enterprises, variables such as a number of filed T10 tax forms (required for reporting on tax matters associated with overseas transactions), amount of gross receipts and sector dummies were regressed on the total tax compliance costs. It was estimated that a 10% increase in the number of T10 forms (signifying 10% increase in the volume of overseas transactions) would result in 2.6% increase in tax compliance costs, while a 10% increase in gross receipts would result in tax compliance costs increasing by 4.1%. These results were compatible with Slemrod and Blumenthal<sup>65</sup> showing that tax compliance costs increase with the business size, although less than proportionately.

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average” <<https://www.ird.govt.nz/resources/8/d/8de01e54-60d4-49ad-9e89-dd185007c345/mid-month-nov-2018.pdf>> (last accessed 27 December 2018).

<sup>63</sup> CA\$352.5 million (NZ\$393 million) in 2018. See Trading Economics, above n 62, for the Canada GDP deflator and IRD, above n 62, for the CA\$-NZ\$ exchange rate.

<sup>64</sup> CA\$1.3 million (NZ\$1.45 million) in 2018. See Trading Economics, above n 62, for the Canada GDP deflator and IRD, above n 62, for the CA\$-NZ\$ exchange rate.

<sup>65</sup> Slemrod and Blumenthal, above n 26.



#### 2.4.1.3 Hong Kong Public Enterprises

Chan, Ariff and Loh<sup>66</sup> investigated the magnitude and composition of tax compliance costs of publicly listed companies in Hong Kong using data on listed companies' tax compliance costs incurred during the 1995-1996 tax year. The survey was mailed out to 496 listed companies with 75 companies responding (giving a total response rate of 15.1%). For facilitating the analysis, survey respondents were further categorised into three groups based on their size. Group 1 contained listed enterprises with sales volumes of less than HK\$100 million (NZ\$18.3 million),<sup>67</sup> Group 2 contained listed enterprises whose annual sales were between HK\$100 million (NZ\$18.3 million)<sup>68</sup> and HK\$550 million (NZ\$100.7 million)<sup>69</sup> and Group 3 included the remaining listed enterprises with sales volumes above HK\$550 million (NZ\$103.7 million).

The overall tax compliance costs for the listed Hong Kong enterprises was estimated to be on average HK\$346,483<sup>70</sup> per company. The average tax compliance costs, calculated separately for each group, were HK\$85,950,<sup>71</sup> HK\$272,410<sup>72</sup> and HK\$465,339<sup>73</sup> for enterprises in Groups 1, 2 and 3, respectively. The estimations of the tax compliance costs obtained for each group of enterprises show that tax compliance costs tend to increase in absolute value as the size of enterprise increases. However, a further calculation of the magnitude of tax compliance costs per HK\$1,000 of sales revealed that tax compliance costs tend to fall as sales volume

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<sup>66</sup> Chan, Ariff and Loh, above n 27.

<sup>67</sup> HK\$ - NZ\$ 1996 average exchange rate (1HK\$=NZ\$ 0.18). Reserve Bank of New Zealand "Exchange Rates and TWI – B1" <<https://www.rbnz.govt.nz/statistics/b1>> (last accessed 27 December 2018).

<sup>68</sup> See above n 67.

<sup>69</sup> See above n 67.

<sup>70</sup> As the Hong Kong GDP deflator increased by 9% from 1996 to 2018, this equates to HK\$ 377,670 in 2018. See Trading Economics "HK GDP Deflator" <<https://tradingeconomics.com/hong-kong/gdp-deflator>> (last accessed 26 December 2018). This is equivalent to NZ\$69,297 as at 15 November 2018. See IRD "Currency rates –rolling average" <<https://www.ird.govt.nz/resources/8/d/8de01e54-60d4-49ad-9e89-dd185007c345/mid-month-nov-2018.pdf>> (last accessed 26 December 2018).

<sup>71</sup> HK\$93,685 (NZ\$17,189) in 2018. See Trading Economics, above n 70, for Hong Kong GDP deflator and IRD, above n 70, for the HK\$-NZ\$ exchange rate.

<sup>72</sup> HK\$296,926 (NZ\$54,481) in 2018. See Trading Economics, above n 70, for Hong Kong GDP deflator and IRD, above n 70, for the HK\$-NZ\$ exchange rate.

<sup>73</sup> HK\$507,219 (NZ\$93,067) in 2018. See Trading Economics, above n 70, for Hong Kong GDP deflator and IRD, above n 70, for the HK\$-NZ\$ exchange rate.

increases. For example, tax compliance costs per HK\$1,000 of sales were HK\$ 5.41, HK\$1.17 and HK\$0.21 for enterprises in Groups 1, 2 and 3, respectively. This trend is the consequence of economies of scale.

The composition of the tax compliance costs revealed that the smaller listed enterprises (Group 1) were using the assistance of external advisers in regard to tax computational activities more often compared to larger listed enterprises (Group 3). Furthermore, it was noted that tax planning costs were 39% of the overall tax compliance costs for the enterprises from Group 3, while Group 1 companies' costs of tax planning were only 13% of the total costs. This may imply that tax planning was more relevant for the larger listed companies and the costs associated with tax planning also grew with the size of turnover. Moreover, in the case of the enterprises included in Group 3, tax planning costs were almost 42% of the total external costs, with the remaining costs related to computational activities. In contrast, in the case of the enterprises from Group 1, tax planning costs were only 12% and computational costs were 88% of the total external costs of tax compliance. This finding indicates that the composition of the external tax compliance costs in smaller and large enterprises is different. The share of non-computational external services, for example, tax planning, is larger for large enterprises.

In addition, simple regression analysis was employed in the study in order to ascertain the effect of sales volume on the costs of tax compliance activities. The regression results showed that, on average, a 10% increase in sales would translate into 0.363% increase in tax compliance costs. The fact that the value of the slope parameter (0.363) was less than 1 suggested the effect of economies of scales and was consistent with the results obtained by Slemrod and Blumenthal<sup>74</sup> and Erard.<sup>75</sup>

The effect of the type of business activity on the magnitude of tax compliance costs was also examined in the study. All of the responding enterprises were divided into four categories according to their main activity. Group 1 enterprises were manufacturing firms; Group 2 were utility enterprises; Group 3 enterprises were from the commerce and trading sector; and Group 4 contained enterprises engaged in finance, investment, real estate and transport activities. The results of the tax compliance costs obtained for each group revealed that the highest level

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<sup>74</sup> Slemrod and Blumenthal, above n 26.

<sup>75</sup> Erard, above n 48.

of tax compliance costs of HK\$581,467 <sup>76</sup> was incurred by the enterprises from Group 2 (utility) followed by Group 4 enterprises (finance, investment, real estate and transport) with the costs of tax compliance of HK\$464,594.<sup>77</sup> However, the estimation of the tax compliance costs incurred per HK\$1,000 of sales by enterprises in each group, showed that mean tax compliance costs were HK\$0.58, HK\$1.53, HK\$0.78 and HK\$2.19 per HK\$1,000 of sales in each of four groups, respectively.

## *2.4.2 Studies conducted in the 2000s*

### *2.4.2.1 Indonesian Large Enterprises*

The study by Susila and Pope<sup>78</sup> examined the tax compliance costs among the population of 28,681 large Indonesian enterprises registered in Large and Medium Taxpayer Offices. The sample consisting of 3,000 enterprises was taken by the way of random stratified sampling using the business sector as the strata. Following the creation of the sample, the questionnaires were mailed out to the potential respondents with 246 responses being received (8.2% response rate). The composition of the large enterprises in the sample, measured by the amount of turnover was: 6 enterprises (2%) below the lowest established threshold of Indonesian Rupee (IDR) 3 billion (NZ\$ 451,127)<sup>79</sup> and 97 enterprises (39%) over the highest established threshold of IDR100 billion (NZ\$ 15.27 million).<sup>80</sup> The remainder of the enterprises were between these two thresholds.

The estimation of the tax compliance costs, based on the results of the survey, showed that in 2010, the weighted average of the tax compliance costs per enterprise was IDR420.9

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<sup>76</sup> HK\$633,799 (NZ\$116,293) in 2018. See Trading Economics, above n 70, for Hong Kong GDP deflator and IRD, above n 70, for the HK\$-NZ\$ exchange rate.

<sup>77</sup> HK\$506,407 (NZ\$92,918) in 2018. See Trading Economics, above n 70, for Hong Kong GDP deflator and IRD, above n 70, for the HK\$-NZ\$ exchange rate.

<sup>78</sup> Susila and Pope, above n 16.

<sup>79</sup> IDR - NZ\$ 2010 average exchange rate (1NZ\$=IDR 6,550). Reserve Bank of New Zealand. "Exchange Rates and TWI – B1" <<https://www.rbnz.govt.nz/statistics/b1>> (last accessed 27 December 2018).

<sup>80</sup> See above n 79.

million.<sup>81</sup> The largest tax compliance costs of IDR506 million<sup>82</sup> per enterprise was found in the retail and wholesale sector, followed by the manufacturing sector with the overall tax compliance burden per manufacturing enterprise of IDR488.8 million.<sup>83</sup> The sector featuring the smallest tax compliance costs was the mining and extraction sector, where cost of tax compliance per enterprise was estimated to be of average IRD51.4 million.<sup>84</sup>

Overall tax compliance costs were further broken down by components. Cost of routine tax compliance activities implemented internally accounted for 54% of the total tax compliance costs, while cost of routine compliance undertaken externally was only 9% of the total costs. Moreover, among external costs, which accounted for 27% of the total costs, almost 48% were costs associated with tax audit, litigation and tax appeal. The balance of external costs were associated with routine compliance and tax reviews. The above composition of internal and external costs of large Indonesian enterprises indicates that a large part of routine tax compliance activities are performed in-house, while most of the legal services are outsourced to external advisers.

It was also established that tax compliance costs increased with the size of an enterprise measured in terms of turnover amount, although less proportionately due to the well-established concept in the literature of the effect of economies of scale. Thus, total tax compliance costs per 1IDR were IDR0.112 for enterprises with annual turnover less than IRD3 billion and IDR 0.004 for enterprises with annual turnover above IRD100 billion.

The authors further performed a calculation in order to demonstrate the percentage share of overall tax compliance costs relative to indicators such as Gross Domestic Product (GDP) and

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<sup>81</sup> As the Indonesia GDP deflator increased by 37% from 2010 to 2018, this equates to IDR 576.6 million in 2018. See Trading Economics “Indonesia GDP Deflator” <<https://tradingeconomics.com/indonesia/gdp-deflator>> (last accessed 27 December 2018). This is equivalent to NZ\$58,663 as at 15 November 2018. See IRD “Currency rates – rolling average” <<https://www.ird.govt.nz/resources/8/d/8de01e54-60d4-49ad-9e89-dd185007c345/mid-month-nov-2018.pdf>> (last accessed 27 December 2018).

<sup>82</sup> IDR 693.22 million (NZ\$70,528) in 2018. See Trading Economics, above n 81 for the Indonesia GDP deflator and IRD, above n 81, for the IDR-NZ\$ exchange rate.

<sup>83</sup> IDR 669.66 million (NZ\$68,131) in 2018. See Trading Economics, above n 81 for the Indonesia GDP deflator and IRD, above n 81, for the IDR-NZ\$ exchange rate.

<sup>84</sup> IDR 70.4 million (NZ\$7,162) in 2018. See Trading Economics, above n 81 for the Indonesia GDP deflator and IRD, above n 81, for the IDR-NZ\$ exchange rate.

National Tax Revenue from large enterprises. The mean tax compliance costs estimated for each sector was multiplied by the number of large entities in the population of each sector. Overall tax compliance costs for the whole population of registered large enterprises turned out to equal IDR12.3 trillion,<sup>85</sup> which in percentage terms was equivalent to 0.19% of Indonesian GDP in 2010 and 3.6% of the total tax revenue collected from large enterprises in 2010.

#### *2.4.2.2 Australian Large Enterprises*

Finally, in a study by Evans, Lignier and Tran-Nam,<sup>86</sup> the cost of tax compliance was measured in the large corporate sector in Australia for the 2011-2012 fiscal year. In this study a sample of large and very large enterprises consisting of 187 entities was drawn by disproportionate stratified random sampling from the population of 1,850 large businesses and international groups in Australia. Large enterprises were defined as entities with an annual turnover over AU\$100 million (NZ\$130 million),<sup>87</sup> whereas very large enterprises were defined as entities with an annual turnover greater than AU\$250 million (NZ\$325 million).<sup>88</sup> An electronic survey was used as the primary method of data collection. 79 usable responses were received, giving a 42% response rate. Among the factors mentioned by the authors as contributing to the high response rate were: endorsement of the survey by the Australian Taxation Authority (ATO) and professional bodies; assistance from the ATO and professional bodies in development of the survey frame; and valuable input made by specific advisory groups into the development of the survey.<sup>89</sup>

An estimation of the external costs of tax compliance revealed that the mean annual external costs of tax compliance incurred in 2011-2012 fiscal year by the large corporate sector in

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<sup>85</sup> IDR16.8 trillion (NZ\$1.7 billion) in 2018. See Trading Economics, above n 80 for the Indonesia GDP deflator and IRD, above n 80, for the IDR-NZ\$ exchange rate.

<sup>86</sup> Evans, Lignier and Tran-Nam, above n 29.

<sup>87</sup> AU\$-NZ\$ 2012 average exchange rate (1 AU\$ = 1.3 NZ\$). Reserve Bank of New Zealand “Exchange Rates and TWI – B1” <<https://www.rbnz.govt.nz/statistics/b1>> (last accessed 28 December 2018).

<sup>88</sup> See above n 87.

<sup>89</sup> Evans, Lignier and Tran-Nam, above n 29, at 768.

Australia was AU\$1.029 million.<sup>90</sup> Analysis of the costs breakdown indicated that 60% of the total external costs of tax compliance were related to income tax, while expenses on Goods and Service Tax (GST) were only 9%, which was in contrast to SMEs, who “relied heavily on external services for GST”.<sup>91</sup> In relation to the type of external services, only 37% of external expenditures related to record keeping, preparation and lodgement of taxes, while another 27% were expenditures on tax planning and 23% related to tax review, audit and litigation. This finding suggested that the composition of cost of tax compliance in large enterprises in Australia was different from the composition of tax compliance costs in SMEs and that the type of external services provided for large enterprises was different from the type of external services provided for SMEs, where 80% of all external costs were related to record keeping, preparation and filing of tax returns.<sup>92</sup>

Internal costs of tax compliance were estimated based on the monetary value of the time that internal staff in large Australian enterprises spend on tax compliance activities and on non-labour costs, which comprised expenditures on office space, specialised tax software and staff training. For the costs of internal staff time, the mean value was estimated to be AU\$1.37 million<sup>93</sup> for 2011-2012 fiscal year. As in the case of external costs of tax compliance, the largest part of internal costs of tax compliance was related to income tax, estimated as 53% of total internal costs of tax compliance. One interesting finding in relation to the composition of the internal costs of tax compliance is that, in contrast to SMEs, a large portion of internal costs was attributed to provision of professional advice on matters such as tax planning, and tax review and litigation.

Non-labour internal tax compliance costs were estimated to be on average AU\$603,000,<sup>94</sup> among which expenses on office space took up almost half, while software expenses were

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<sup>90</sup> As Australia GDP deflator increased by 7% from 2012 to 2018, this equates to AU\$1.1 million in 2018. See Trading Economics “Australia GDP Deflator” <<https://tradingeconomics.com/australia/gdp-deflator>> (last accessed 28 December 2018). This is equivalent to NZ\$1.2 million as at 15 November 2018. See IRD “Currency rates – rolling average” <<https://www.ird.govt.nz/resources/8/d/8de01e54-60d4-49ad-9e89-dd185007c345/mid-month-nov-2018.pdf>> (last accessed 28 December 2018).

<sup>91</sup> Evans, Lignier and Tran-Nam, above n 29, at 777.

<sup>92</sup> At 777.

<sup>93</sup> AU\$1.47 million (NZ\$1.9 million) in 2018. See Trading Economics, above n 90, for the Australia GDP deflator and IRD, above n 90, for the AU\$-NZ\$ exchange rate.

<sup>94</sup> AU\$645,000 (NZ\$838,773) in 2018. See Trading Economics, above n 90, for the Australia GDP deflator and IRD, above n 90, for the AU\$-NZ\$ exchange rate.

19%, with the rest attributable to staff training. Installation of specialised software in-house enables large Australian enterprises to undertake large amount of tax compliance activities internally.

The percentage composition of internal and external costs of tax compliance indicated that internal costs were approximately 46.7% of the gross tax compliance costs, while external costs accounted for 34.2%. The remaining 20% of the tax compliance costs were associated with non-labour costs. It is worthwhile to note that of the total costs associated with record keeping and tax computational activities (basic tax compliance activities), 60% were generated in-house, while the other 40% of the cost of the basic tax compliance activities were generated externally. This result implies that, although large enterprises in Australia retain less record keeping and computational activities in-house in comparison to US and Canadian large enterprises, they nevertheless rely more on internal resources when it comes to implementation of the basic tax compliance functions.

Estimation of the gross compliance costs, consisting of internal and external costs, revealed that in relation to AU\$1,000 of turnover, the compliance costs of large Australian enterprises were AU\$0.40. In comparison to Australian SMEs, where per AU\$1,000 of turnover gross tax compliance costs were estimated to be AU\$3.34, tax compliance burden is much less for large enterprises in Australia. Consequently, this study confirms regressive nature of tax compliance costs.

The determinants of the tax compliance costs were further examined through a questionnaire and the use of statistical methods. Responses provided by the Australian large enterprises in the sample revealed that complexity of tax law, number of different tax laws which the group has to comply with, uncertainty of the wording of tax law and the frequency of changes in tax legislation were perceived as main drivers of the compliance costs. Statistical analysis was undertaken in line with Slemrod and Blumenthal,<sup>95</sup> estimating the effect of variables such as turnover size, number of entities in a group, number of taxes and risk classification of a large enterprises in the ATO on gross, external and internal costs of tax compliance. The results of the regression showed a strong effect of turnover size and number of entities in a group on all three categories of the tax compliance costs. The values of the coefficients obtained were less than 1, implying that although, costs of tax compliance were increasing with the increase in

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<sup>95</sup> Slemrod and Blumenthal, above n 26.

the business size, the increase in the costs of tax compliance was less than proportionate. The risk classification with the ATO had effect only on external costs of tax compliance, particularly on costs associated with review, audit and litigation. However, the study could not conclude whether risk classification itself was a cost driver or tax aggressiveness of a group was the reason of a group risk classification.

## *2.5 Summary of Findings from Studies on Large Enterprises*

### *2.5.1 Main Findings*

In summary, all five studies presented above deal specifically with large enterprises and seek to measure their tax compliance costs. Although these studies were undertaken in different jurisdictions, they nevertheless produced fairly consistent results.

First, tax compliance costs of large enterprises are substantially high in their absolute value, being estimated as 2.6% of tax revenue collected from US large enterprises in the case of US large enterprises, 5% of tax revenue in the case of Canadian large enterprises, and 3.6 % of the total tax revenue in the case of large enterprises in Indonesia. Although, no comparison of the estimated tax compliance costs of large enterprises in Australia with tax revenue was undertaken in Evans, Lignier and Tran-Nam's study,<sup>96</sup> the costs of tax compliance of Australian large enterprises was found to be even higher (in AU\$ terms) than in the case of large enterprises in the US and Canada.<sup>97</sup>

Second, all five studies demonstrated that, although tax compliance costs tend to increase with business size, they do so less than proportionately due to economies of scale. Third, the regression analysis undertaken by Slemrod and Blumenthal,<sup>98</sup> Erard,<sup>99</sup> Chan, Ariff and Loh,<sup>100</sup> and Evans, Lignier and Tran-Nam,<sup>101</sup> showed that the factors such as worldwide presence, volume of overseas transactions, type of industries in which large enterprise

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<sup>96</sup> Evans, Lignier and Tran-Nam, above n 29.

<sup>97</sup> At 781.

<sup>98</sup> Slemrod and Blumenthal, above n 26.

<sup>99</sup> Erard, above n 48.

<sup>100</sup> Chan, Ariff and Loh, above n 27.

<sup>101</sup> Evans, Lignier and Tran-Nam, above n 29.



operates, size of turnover and number of entities in a group, are drivers of tax compliance costs.

Fourth, the composition of the tax compliance costs in large enterprises presented in all five studies showed that activities relating to record keeping, computation and filing of tax returns account for 37% to 60% of the total compliance costs. The remainder of the costs are predominately associated with tax planning, audit and litigation, with a small fraction of other compliance-related expenditures. This implies that the composition of the costs of tax compliance in large enterprises is different from the composition of tax compliance costs in SMEs, where the majority of the costs are associated with record keeping and the preparation of tax returns.<sup>102</sup>

Most of the computational activities related to tax compliance are done in-house, except for smaller public enterprises in Hong Kong, where reliance on external advisors in this regard was found to be greater in comparison with large enterprises from the studies in the US, Canada, Indonesia and Australia. This finding points to the fact that large enterprises appear to be more efficient than SMEs in relation to computational activities and the preparation of tax returns. Therefore their reliance on external tax advisers for computational activities is smaller. Based on the composition of tax compliance costs in each of the five studies, it appears that the outsourcing of tax compliance activities mostly related to tax audit, appeal and litigation to external parties is customary for large enterprises. Eichfelder and Vaillancourt<sup>103</sup> provide some evidence that as the size of business increases, the costs relating to audit and litigation increase, while costs of record keeping and tax computational activities becomes less relevant. This implies that large enterprises are largely cost efficient in relation to record keeping and computational activities.

In relation to the costs of tax planning activities, it is difficult to conclude from these studies if there is a strong connection between tax planning costs and business size, as none of the studies (except for the Hong Kong study) provides a breakdown of tax planning costs by the size of the respondent enterprises. Thus, the Hong Kong study demonstrates that the costs of tax planning activities are significantly higher for the enterprises with the highest turnover

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<sup>102</sup> At 777.

<sup>103</sup> Sebastian Eichfelder and Francois Vaillancourt “Tax Compliance Costs: A Review of Cost Burdens and Cost Structures” (Arqus Discussion Paper No. 178, 2014) at 21.

compared to enterprises with the lowest turnover. Eichfelder and Vaillancourt<sup>104</sup> argue that tax planning costs tend to increase with the size of business. Slemrod<sup>105</sup> provides a theoretical explanation of how economies of scale affect tax avoidance. In line with his explanation, since large enterprises are cost efficient in record keeping and computational activities, which are implemented in-house, they also become cost efficient in tax planning.

For a better illustration, a quick summary of the studies discussed above is provided below in Table 2.1.

**Table 2. 1: Overview of studies on the cost of tax compliance of large enterprises**

Authors	Year	Definition	Data Collection Method	Magnitude	Composition	Drivers
Slemrod and Blumenthal	1996	More than 2,500 employees or annual sales turnover above NZ\$412 million	Mail survey	-NZ\$ 4.49 billion of tax compliance costs (2.6% of tax revenue from large US enterprise)  -Federal income tax is the most costly tax to comply with	Internal – 80% External – 20%  Record keeping/tax filing – 50%  Audit/ litigation/tax planning – 35%  90% of record keeping/tax filing done in-house  40% of tax planning/audit done externally	Enterprise size,  Sector,  Worldwide presence
Erard	1997	8,568 employees, or NZ\$3.24 billion of gross receipts and assets worth NZ\$3.87 of book value	Mail survey	- NZ\$ 1.45 million per large enterprise (2.7 % of tax revenue from large enterprises in Canada)	Internal – 56.9% External – 20.6%  Non-personnel – 22.5%  46 % of record keeping/tax filing – in-house  9.5% of record keeping/tax filing – externally	Enterprise size,  Overseas transactions

<sup>104</sup> Eichfelder and Vaillancourt, above n 103, at 23.

<sup>105</sup> Joel Slemrod “A general model of the behavioural response to taxation” (2001) 8 International Tax and Public Finance 119.

					<p>53% of tax planning/audit – externally</p> <p>37% of appeals/litigation – externally</p>	
Chan, Ariff and Loh	1996	<p>Three groups of listed enterprises with annual turnover:</p> <p>1.NZ\$18.3 million</p> <p>2.NZ\$18.3 million - NZ\$100.7 million</p> <p>3.Over NZ\$103.7 million</p>	Mail survey	<p>- NZ\$ 17,189 for enterprises from group 1</p> <p>- NZ\$ 54,481 for enterprises in group 2</p> <p>- NZ\$ 93,067 for enterprises in group 3</p>	<p>Hon-Kong enterprises rely to a high degree on external tax practitioners in regard to record keeping/tax filing</p> <p>Group 1:</p> <p>Record keeping/tax filing – 88% of the total external cost.</p> <p>Tax planning – 12% of the total external costs</p> <p>Group 3:</p> <p>Record keeping/tax filing – 61% of the total external cost</p> <p>Tax planning – 39% of the total external costs</p>	Enterprise size, Sector
Susila and Pope	2012	Enterprises with an annual threshold above NZ\$ 451,127	Mail survey	<p>-Average tax compliance cost NZ\$ 58,663</p> <p>- 0.19 % of Indonesian GSD in 2010</p> <p>- 3.6% of total tax revenue collected from large enterprises in 2010</p>	<p>54% of record keeping/tax filing – in-house</p> <p>9% of record keeping/tax filing – externally</p> <p>More than 48% of external cost are : audit/litigation and appeal</p>	Enterprise size
Evans, Lignier and Tran-Nam	2016	Enterprises with an annual turnover above	Electronic survey	<p>- Average tax compliance cost NZ\$ 1.1 million</p> <p>- Income tax is the most</p>	<p>Internal costs – 46.7%</p> <p>External cost – 34.2%</p> <p>Non-labour cost – 20%</p>	Enterprise size Number of entities in a group

		NZ\$130 million		costly tax to comply with:  - 60% of external costs  -53% of internal costs	Record keeping/tax filing – 60% generated internally, 40% generated externally  Tax planning – 27% of external costs  Tax review/audit/litigation – 23%	
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### *2.5.2 Limitations of the Studies*

The studies discussed above have several limitations which are discussed below. First, despite focusing on “large enterprises”, none of the studies attempts to analyse what entity can be defined as large prior to determining their representative sample. As we have seen earlier in this chapter, each study draws a representative sample that consists of entities, defined as large according to criteria adopted by the tax revenue authority. Since the revenue authority designs the definition criteria for its own purposes, there is a risk that a sample of entities, defined as large according to these criteria might not be representative of an actual population of large enterprises. Moreover, use of only quantitative criteria, such as the number of employees, sales volume or value of assets, to define an enterprise as large, seems convenient for empirical estimation, but has an obvious deficiency which is related to uncertainty of where to draw the line that separates large enterprises from SMEs. Perhaps, one of the possible ways to define a large enterprise more accurately would be to include qualitative criteria that describe large enterprise in terms of its inherent characteristics.

Second, more analysis of the determinants of tax compliance costs of large enterprises is required, particularly in regard to the overseas business operations. Given that most of the studies on large enterprises, except for the studies in Indonesia and Australia, were conducted at least 20 years ago, the expansion of business operations of large enterprises beyond the border of a single jurisdiction and increased complexity of cross-border transactions, merit a more thorough investigation into effect of cross-border transactions on tax compliance costs of large enterprises.

Third, none of the prior studies attempted to estimate whether large enterprises use cost efficient tax compliance administration. Large enterprises usually have a choice of resources to deal with their tax compliance obligations, which generally include in-house personnel, specialised software and services provided by external tax practitioners. Therefore, a cost efficient mix of these resources can also assist in reducing costs of tax compliance. In accordance with the rational choice theory, which will be elaborated in more detail in Chapter 5 of this thesis, firms are expected to choose a cost minimising mix of resources. Thus, empirical analysis in the framework of the rational choice theory could provide more insight into whether large enterprises in a particular jurisdiction use the cost-efficient tax compliance administration. If large enterprises do not use cost-efficient tax compliance administration, then this analysis can further assist in determining what resources are used inefficiently and how the change of the particular resource or mixture of resources can reduce costs of tax compliance.

## Chapter 3: Defining Large Enterprises in New Zealand

### 3.1 Introduction

As already mentioned in the introductory chapter of this thesis, and further demonstrated in the Chapter 2, none of the prior studies of tax compliance costs has provided a clear definition of what a large enterprise is. Therefore, it appears that there is no unified definition of a large enterprise, either in New Zealand or in a number of other jurisdictions. The prior studies examined have shown that the government agencies in each jurisdiction characterises large enterprises differently, both in terms of the criteria and the thresholds applied. Interestingly, large enterprises may not even have an official definition – they logically follow from the official definitions established for Small and Medium Enterprises (SMEs). Thus, upon examination of the definition for SMEs adopted by the European Commission, it can be concluded that an enterprise with a number of employees above 250 and annual turnover or assets value over EURO50 million (NZ\$84.7 million)<sup>1</sup> is considered large by the European Commission.<sup>2</sup> At the same time according to the criteria and thresholds adopted by the World Bank<sup>3</sup> for classifying SMEs, a large enterprise is a business entity where the number of staff exceeds 300 and the value of total assets or the amount of total annual sales is above US\$15 million (NZ\$21.7 million).<sup>4</sup>

In the case of New Zealand, whether an entity can be classified as large, depends on which criteria, and their thresholds, are used. For example, the Ministry of Business, Innovation and Employment (MBIE) considers an entity that has over 100 employees<sup>5</sup> as large. In contrast, an entity with an annual turnover of more than NZ\$30 million or assets over NZ\$60 million is

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<sup>1</sup> Euro-NZ\$ exchange rate (1 NZ\$ =0.59 EURO) as at 15 November 2018. See IRD “Currency rates – rolling average” <<https://www.ird.govt.nz/resources/8/d/8de01e54-60d4-49ad-9e89-dd185007c345/mid-month-nov-2018.pdf>> (last accessed 29 December 2018).

<sup>2</sup> Commission of the European Communities “Commission recommendation concerning the definitions of micro, small and medium sized enterprises” (2003) L 124 Official journal of the European Union 36.

<sup>3</sup> Independent Evaluation Group “Financing micro, small, and medium Enterprises: An Independent Evaluation of IFC’s experience with financial intermediaries in frontier countries” (International Finance Corporation, World Bank Group, 2008) at 5.

<sup>4</sup> US\$ - NZ\$ exchange rate (1NZ\$ = 0.69 US\$) as at 15 November 2018. See IRD “Currency rates – rolling average” <<https://www.ird.govt.nz/resources/8/d/8de01e54-60d4-49ad-9e89-dd185007c345/mid-month-nov-2018.pdf>> (last accessed 29 December 2018).

<sup>5</sup> MBIE “The small business sector report” (2014).

considered large under the criteria established in the New Zealand Financial Reporting Act 2013 (FRA 2013).<sup>6</sup>

New Zealand's Inland Revenue (IR) uses a NZ\$100 million<sup>7</sup> annual turnover threshold to define large enterprises. However, this definition is used in the context of the customer service function and includes tax exempt organisations like Crown entities<sup>8</sup> which are not part of the IR's tax compliance focus. For tax compliance purposes the IR applies the term "significant enterprise", which will be discussed in more detail in Chapter 6 of this thesis. For the purpose of this chapter it is suffice to say that a significant enterprise with an annual Goods and Services Tax (GST) turnover greater than NZ\$80 million will be considered as a "large enterprise" by the IR for tax compliance purposes.<sup>9</sup>

The array of existing criteria and thresholds describing large enterprise create ambiguity regarding which enterprises should be considered as large in New Zealand. If the thresholds applied to define large enterprises across industries are also taken into account, the perception of a large enterprise becomes even more blurred. It follows that, taking any of the official definitions as a benchmark for measuring the size of an entity cannot produce a reliable representative sample of the "true" large enterprises simply because each of these definitions has different views on what entity to consider as "large". As an example, the MBIE estimates according to its criteria, that large enterprises in New Zealand account for 0.4% of the total number of business entities.<sup>10</sup>

However, statistics from the IR provides a different number of the large enterprises in New Zealand (0.2% of all registered entities).<sup>11</sup> It should be noted that the large enterprises included in the IR's statistics, are defined as enterprises with NZ\$100 million turnover and include tax

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<sup>6</sup> Financial Reporting Act 2013 (FRA 2013), s 45(1)(a).

<sup>7</sup> IR "Tax statistics definitions" <<https://www.ird.govt.nz/aboutir/external-stats/tax-statistics-definitions.html>> (last accessed 24 December 2018).

<sup>8</sup> Email from Stephen Casey (International Revenue Strategy team) to the researcher regarding the definition of large enterprises in New Zealand (25 September 2018). See also above n 7.

<sup>9</sup> From the interview with an IR tax official (5 April 2018) transcript provided by the researcher. Significant enterprises and the interview with an IR official are elaborated upon in Chapter 5 and 6 of this thesis, respectively.

<sup>10</sup> Statistics New Zealand "Business demography statistics" <[http://nzdotstat.stats.govt.nz/wbos/Index.aspx?DataSetCode=TABLECODE7604&\\_ga=2.263378116.975941172.1545634605-2096137522.1543898237#](http://nzdotstat.stats.govt.nz/wbos/Index.aspx?DataSetCode=TABLECODE7604&_ga=2.263378116.975941172.1545634605-2096137522.1543898237#)> (last accessed 26 December 2018).

<sup>11</sup> IR "Registered customers by groups 2008-2017" <<https://www.ird.govt.nz/aboutir/external-stats/customers/reg-by-customer-group/customers-reg-cust-by-groups.html>> (last accessed 23 December 2018).

exempt organisations. Therefore, depending upon which criteria are used as a reference, the population of large enterprises in New Zealand may fluctuate across a range of 0.2% and 0.4%. Moreover, considering that the IR statistics includes tax exempt organisations, the population of large enterprises, which are the focus of tax compliance costs study, should be even less than 0.2%.

When government officials discuss the important role (measured by the contribution to GDP growth, employment and tax revenue) that large enterprises play in the national economy, how can they be certain that these are indeed “large enterprises” that they are talking about given that the term “large enterprise” itself is not clearly defined? Where can the line that separates SMEs from large enterprises in New Zealand be drawn? Therefore, a question arises from the above discussion: is it possible to have a unified definition for the term “large enterprise” which would reflect the distinctive characteristics of large businesses and be operational for statistical purposes?

In the light of the existing uncertainty with the term “large enterprise”, this chapter undertakes an explorative analysis of various types of criteria that can help to provide a definition of the large enterprise in New Zealand. This analysis is necessary in order to determine the population of large enterprises in New Zealand so that further research (predominately empirical) in the area of the costs of tax compliance of large enterprises can be conducted.

The remaining content of the chapter is as follows. First, a brief introduction to the past studies on the issue of large enterprise definitions will be provided. Second, discussion on the quantitative and qualitative approaches to the definition of large enterprises, with a focus on the role that qualitative criteria play in defining large enterprises, will be presented. Finally, the last section summarises the information provided in this chapter.

### *3.2 Review of the Literature on the Definition of Large Enterprises*

As is the case with the absence of a unified definition of large enterprises, the research literature does not have any notable academic publications relating to the study of the problem surrounding the definition of a large enterprise. Perhaps the only available study providing



some insights into the official definition of the large enterprises is the specialised report prepared by the Intra-European Organisation of Tax Administrations in 2008.<sup>12</sup>

This report presented the results of a survey conducted among 39 European Union (EU) member and non-member countries for the purpose of establishing whether the term “large taxpayer” had a legal definition, and what criteria were applied to classify large taxpayer in each participating country. According to the results, 45% of the countries had a legal definition and another 45% used other definitions and guidance to define the term “large taxpayer”. Ten percent of the countries participating in the survey had no definition or other description of a large taxpayer.<sup>13</sup> The report further revealed that the most common criteria used to describe large taxpayers were the value of turnover (79%), number of employees (29%), amount of taxes paid (29%), and assets value (18%).<sup>14</sup> Although this report serves as a useful source of information about the various definitions classifying large taxpayers by the tax authorities in different jurisdictions, it does not provide any analysis of what entity can be considered as a large enterprise based on the features that characterise large enterprises.

In contrast to the lack of attention to the definitional issue of large enterprises, research has shown a greater interest towards finding a better way to define a SME. This is not surprising given the heightened interest that governments and economists have in the growth and development of SMEs, which they consider to be the “backbone of the economy”.<sup>15</sup> Consequently, establishment of a unified definition of what constitutes a “true” SME could assist in identifying the groups of business entities that would match the criteria of that “true” SME, ensuring that government’s support of SMEs is delivered to the right recipient. However, according to Berisha and Pula, this issue is far from being resolved.<sup>16</sup>

Berisha and Pula,<sup>17</sup> in their critical review of the problem of defining SMEs, note that the SME definition issue is not only far from being resolved, but is also not widely acknowledged. They

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<sup>12</sup> Intra-European Organisation of Tax Administrations “Definition of ‘Large Taxpayer’: IOTA Report for Tax Administrations” (2008).

<sup>13</sup> At 5.

<sup>14</sup> At 8.

<sup>15</sup> Gentrit Berisha and Jastina Pula “Defining Small and Medium Enterprises: a critical review” (2015) 1 Academic Journal of Business, Administration, Law and Social Science 17 at 17.

<sup>16</sup> Berisha and Pula, above n 15.

<sup>17</sup> Berisha and Pula, above n 15.

state that the strong heterogeneity and inconsistencies in the available SME definitions have resulted in “considerable ambiguity in the terminology used”.<sup>18</sup> They further discuss the use of qualitative criteria and argue that although the qualitative characteristics of SMEs make them easily distinguishable from large enterprises, quantitative criteria are mainly used for the dimensional classification of SMEs.

Another notable study which focuses on the problem around the definition of SMEs was by Gibson and van der Vaart.<sup>19</sup> They argued that due to the inconsistencies amongst official definitions of SMEs, the allocation of government spending for SME development could result in serious distortions and thus a new method to define SMEs was required. A quantitative formula for defining SMEs was proposed as this new method. The formula defines a SME as an entity whose annual turnover, expressed in US\$ terms, is between 10 and 1000 times the mean per capita Gross National Product (GNP) adjusted for the purchasing power parity of the country in which the entity operates.

Gibson and van der Vaart’s formula is based on the following three principles. The first principle is that the use of annual turnover “most closely reflects functional and behavioural attributes”<sup>20</sup> of an entity and therefore generally serves as a more appropriate measure of the relative size of the entity. The second principle concerns consideration of the country-specific economic context which is expressed through the level of GNP adjusted for the purchasing power parity. Finally, the use of the 10 and 1000 multiples for the lower and upper cut-offs reflects the idea of the “dynamic growth” of SMEs. Therefore, scaling the size parameters of SMEs in relation to their home base should help to improve consistencies among multi-country definitions of SMEs. This study perhaps is the first attempt to analyse what the definition of SME should be in the context of the level of economic development, and the formula proposed in this study can be viewed as a convenient universal definition of SMEs.

Although the studies introduced above deal with the problems associated with the ambiguous definitions of SMEs, the ideas presented in them could potentially offer some insights for the current analysis of the problem with the definitions of large enterprises. For example, the idea of using qualitative characteristics and scaling an entity’s annual turnover in relation to the

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<sup>18</sup> At 18.

<sup>19</sup> Tom Gibson and HJ van der Vaart “Defining SMEs: a less Imperfect Way of Defining Small and Medium Enterprises in Developing Countries” (Brookings Global Economy and Development, 2008).

<sup>20</sup> At 14.

country's economic development indexes could be useful in establishing what constitutes a large enterprise in a certain jurisdiction.

### *3.3 Common Criteria Used to Define Large Enterprises*

Before moving to a more detailed discussion of the common criteria which may be used to define a large enterprise, it is worth noting that a population of large enterprises appears to be non-homogeneous in respect to many factors: form and size of organisation; type and scale of activity; and existence of industry/activity specific taxes. Thus, a population of large enterprises includes organisations engaged in a wide range of activities: finance, insurance, resource exploration and energy supply. The concept of a large enterprise becomes even more complicated by the fact that not only a single enterprise but also a group of such single enterprises may fall under the definition of a "large enterprise". A group of enterprises may operate only within New Zealand or across various jurisdictions, have a parent enterprise based in New Zealand or be headquartered offshore. A group of multinational enterprises serve as a prime example of such a group of entities, requiring further consideration as to how to classify them in terms of their size. For instance, if a parent of a multinational group is a New Zealand-based enterprise, then perhaps the size of this multinational group can be measured by the size of its New Zealand parent. However, if a multinational group's parent is headquartered offshore and this multinational group has a presence in New Zealand through a subsidiary, then how do we ascertain the size of this multinational group? Should we measure the size of this multinational group using only the New Zealand subsidiary or should we apply the available criteria to measure the rest of a group?

The heterogeneity observed in the population of large enterprises makes arriving at a unified definition of large enterprises a very difficult task. This heterogeneity requires using different criteria and thresholds for determining if a particular organisation belongs to category of large enterprises. Factors used to describe a large enterprise vary greatly across jurisdictions due to differences in the size of economies, existence of specific industries and the types of taxes levied in particular jurisdictions. These factors, criteria and thresholds also in turn depend upon the purposes for which the definition of large enterprise is required, whether it is for tax, audit or economic policy purposes. Thus, the same organisation might be considered as a large for financial reporting purposes as prescribed by financial reporting regulations but at the same time, will fall short of the threshold established by a tax authority for large enterprises. For the

purpose of economic policy, an organisation might be classified as large, but it may fail to satisfy the criteria of the large organisation established for both audit and tax purposes.

Therefore, the greatest difficulty connected with defining a large enterprise is seen in the unification of the diverse criteria and thresholds adopted to describe this category of enterprises. While the established numerical thresholds are subject to variation due to the various factors mentioned above, criteria based on the intrinsic characteristics of large enterprises could assist in the adoption of the unified definition.

### *3.3.1 Criteria Based on Numerical Values*

An approach, which uses numerical values in order to classify large enterprise is referred as a “quantitative approach”. It enables large enterprises to be identified relatively easily and quickly by measuring the size of an entity in terms of indicators such as number of staff, amount of annual turnover or sales and value of assets. Either some or all of the indicators may be sufficient for measuring the size of an entity. The most common criterion used to distinguish large enterprises from SMEs is the number of employees.<sup>21</sup> As an example, the European Commission defines the size of an entity through three parameters: number of employees, annual turnover or the value of assets (which are both expressed in EURO).<sup>22</sup> Although the European Commission applies these parameters for the official definition of a SME, we can logically extend them in order to define large enterprises. Table 3.1 below presents how the European Commission would define large enterprises on a basis of the definition of SMEs. The threshold values expressed in EURO in the original source are converted to NZ\$.

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<sup>21</sup> Timothy S Hatten *Small Business Management: Entrepreneurship and Beyond* (5<sup>th</sup> ed, South-Western Cengage Learning, Mason, 2011).

<sup>22</sup> Commission of European Communities, above n 2.

**Table 3.1: Definition of large enterprise in accordance with European Union standards**

<b>Enterprise category</b>	<b>Annual Number of Employees</b>	<b>Annual turnover</b>	<b>Value of assets</b>
Large	>250	> EURO50 million (NZ\$85 million) <sup>23</sup>	>EURO50 million (NZ\$85 million)
Medium-sized	<250	< EURO50 million (NZ\$85 million)	< EURO50 million (NZ\$85 million)

Source: European Commission<sup>24</sup>

Another authoritative international institution, the World Bank, also uses three quantitative criteria to define SMEs: number of employees; total assets; and total annual sales. An entity must meet the criterion of the number of employees and at least one of the other two criteria in order to be classified as SME. Since the World Bank applies these criteria in order to provide an official definition of SMEs, the definition of large enterprise can be similarly derived as in the above example with the European Commission.

**Table 3.2: Definition of large enterprise in accordance with World Bank standards**

<b>Enterprise category</b>	<b>Number of employees</b>	<b>Total assets</b>	<b>Total annual sales</b>
Large	>300	> US\$15 million (NZ\$21.6 million) <sup>25</sup>	> US\$15 million (NZ\$21.6 million)
Medium-sized	< 300	< US\$15 million (NZ\$21.6 million)	< US\$15 million (NZ\$21.6 million)

Source: Independent Evaluation Group<sup>26</sup>

<sup>23</sup> EURO–NZ\$ exchange rate as at 15 November 2018. See IRD “Currency rates – rolling average” <<https://www.ird.govt.nz/resources/8/d/8de01e54-60d4-49ad-9e89-dd185007c345/mid-month-nov-2018.pdf>> (last accessed 29 December 2018).

<sup>24</sup> Commission of European Communities, above n 2.

<sup>25</sup> US\$ – NZ\$ exchange rate as at 15 November 2018. See IRD “Currency rates – rolling average” <<https://www.ird.govt.nz/resources/8/d/8de01e54-60d4-49ad-9e89-dd185007c345/mid-month-nov-2018.pdf>> (last accessed 29 December 2018).

<sup>26</sup> Independent Evaluation Group, above n 3.

The comparison of the criteria and their numerical values applied by the European Commission and the World Bank reveals that despite the application of the same criteria, the threshold values established by both institutions differ significantly. Inconsistencies are most pronounced in the financial criteria. Consequently, depending upon whether the thresholds established by the European Commission or by the World Bank are used, the same entity might simultaneously be classified as large enterprises and as SME.

Furthermore, if we take a look at the thresholds established in different countries, the thresholds that apply to each criterion tend to differ between jurisdictions. The following table shows how the number of employees, being the most common criterion,<sup>27</sup> varies across jurisdictions.

**Table 3.3: Differences in the number of employees used to measure the size of an entity across jurisdictions**

<b>Jurisdiction</b>	<b>SME</b>	<b>Large Enterprise</b>
EU countries, Iceland, Norway and Switzerland	1-249	>250
Australia	0-199	>200
Canada	0-499	>500
Japan	1-249	>250
Korea	5-199	>200
New Zealand	0-99	>100
United States	1-499	>500

Source: Organisation for Economic Co-operation and Development (OECD)<sup>28</sup>

It is clear that the thresholds determining where SMEs end and large enterprises commence will differ from country to country due to the relative size of national economies. For instance, according to Table 3.3, an enterprise with a number of employees greater than 100 is considered to be large in New Zealand, while in Japan it is still an SME. Inconsistencies in the thresholds defining SMEs and large enterprises, as indicated in Tables 3.1, 3.2 and 3.3, once again

<sup>27</sup> Berisha and Pula, above n 15, at 20.

<sup>28</sup> OECD “SMEs, Entrepreneurship, and Innovation” (Paris, 2010).

emphasise that numerical criteria are very subjective and classification of an entity as a large enterprise or as a SME depends to a great extent on the interests of the stakeholders. In addition, as all the measurements for large enterprises shown in the tables above are based on the numerical criteria established for SMEs, the definition of large enterprises is therefore solely dependent on these numerical values. As Gibson and Van der Vaart<sup>29</sup> note, existing SME definitions based on numerical parameters are not the result of a scientific division based on microeconomic indicators, but rather are of statistical arbitrariness.

The volatility of the thresholds increases even more when entities are analysed in relation to the sectors within which they operate. Thus, an entity with the same quantitative parameters can be considered as large or small as it moves from one sector to another. The quantitative criteria discussed above define an entity as large in absolute terms but industry-specific characteristics are not taken into account. For example, if we use the number of employees to determine if an entity is large, this criterion has obvious limitations, mainly because the number of staff employed is dependent on the sector in which an entity operates. Therefore, in order to measure the size of entities across sectors in terms of the number of employees it is necessary to use different thresholds, each reflecting the specificity of the sector. If we look at the quantitative definitions used by the United States Small Business Administration<sup>30</sup> we can see that the main criterion defining the size of an entity engaged in agricultural sector as large is turnover over US\$750, 000 (NZ\$1.08 million),<sup>31</sup> while in the mining industry the criterion is the number of employees above 500, and in the wholesale sector the criterion is based on the number of employees over 100.<sup>32</sup>

Despite being a relatively simple and convenient way to identify large enterprises in terms of numerical parameters, the quantitative approach has several drawbacks. First, the choice of the thresholds that apply to criteria used to define a large enterprise largely depend on the interests of the stakeholders – researchers, politicians, international institutions and public authorities. Consequently, the answer to the question “what is a large enterprise?” will depend on who

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<sup>29</sup> Gibson and van der Vaart, above n 19, at 3.

<sup>30</sup> United States Small Business Administration “U.S. Small Business Administration: Table of Small Business Size Standards Matched to North American Industry Classification System Codes” (2017).

<sup>31</sup> US\$ – NZ\$ exchange rate as at 15 November 2018. See IRD “Currency rates – rolling average” <<https://www.ird.govt.nz/resources/8/d/8de01e54-60d4-49ad-9e89-dd185007c345/mid-month-nov-2018.pdf>> (last accessed 29 December 2018).

<sup>32</sup> United States Small Business Administration, above n 30.

answers this question. Second, even unified numerical criteria and the thresholds adopted within certain jurisdiction may not be suitable for measuring the size of an entity across different sectors of economy due to the industry-specific factors. Thus, the market forces of the sector in which an entity is engaged might determine criteria such as sales turnover and number of employees. Therefore, benchmarking the size of entities from different industry sectors against unified criteria and thresholds does not appear to be very meaningful. Finally, due to the differences in the size of national economies it is difficult to apply one measurement standard across many countries in order to define large enterprises in those countries.

### *3.3.2 Criteria Based on Qualitative Features*

As the word “qualitative” suggests, qualitative criteria should describe characteristic features that large enterprises tend to have. Logically, large enterprises differ from SMEs not only by the sheer volume of their operations, but also by criteria such as organisational structure, capital structure and geographical span of operations. The presence of such characteristics might be indicative of the fact that not only is an enterprises large in terms of a size, but also that this enterprise is not an SME.

#### *3.3.2.1. Organisational Structure*

A large enterprise (one that is not SME) is so-called, primarily due to the large scope of its operations. To manage large scale operations successfully it is essential to have an efficient and well-functioning organisational structure. This organisational structure usually delineates the duties and responsibilities of employees and creates hierarchical subordination which links the lowest level employee with the Chief Executive Officer (CEO) of a large enterprise. As large-scale operations require expertise, the hierarchical structure of large enterprises ensure that instructions and commands pass quickly from the top manager (CEO) to departmental managers who have an abundance of expertise in regard to their main functions.<sup>33</sup> Unlike SMEs, where the main management functions are divided between several employees, the organisational structure of a large enterprise usually includes departments, each of which is

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<sup>33</sup> Patrick Gleeson “Organizational and Structural Differences Between Small and Large Businesses” (29 June 2018) Chron <<http://smallbusiness.chron.com/organizational-structural-differences-between-small-large-businesses-10678.html>> (last accessed 25 December 2018).



charged with certain duties and responsibilities. Thus, a large enterprise might have a human resource department, finance and accounting department, logistics department, purchase department, marketing department, each comprising a number of employees.

There are five common types of organisational structures, which are usually adopted by large enterprises. These are as follows:<sup>34</sup>

1. Matrix Organisational Structure
2. Functional Organisational Structure
3. Product Organisational Structure
4. Customer Organisational Structure
5. Geographic Organisational Structure

There is a great deal of debate in the academic literature regarding the link between the size of an enterprise and its organisational structure. Broadly speaking, organisational structures concern two things: 1) work division and 2) coordination mechanisms, which include the standardisation and formalisation of tasks.<sup>35</sup> A higher level of work division, which presumes specialisation and differentiation, leads to greater complexity of an organisation, or “departmentalisation”.<sup>36</sup> The existence of coordination mechanisms in an organisation lead to greater bureaucracy within the organisation.

Meijaard, Brand and Mosselman argue that due to transaction costs and coordination, hierarchical structures are absent or very rare in small enterprises.<sup>37</sup> Based on data from 2000 Dutch firms with less than 100 employees they attempted to test the hypotheses that the larger the firm, the more complex its structure. The results of their study shows that small firms may have a wide variety of organisational structures too. However, the study established a strong positive correlation between firm size and departmentalisation. The study found firms with

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<sup>34</sup> Patricial Lotich “Types of Business Organizational Structures” (24 July 2013) Pingboard <<https://pingboard.com/blog/types-business-organizational-structures/?rel=author>> (last accessed 25 December 2018).

<sup>35</sup> Joris Meijaard, Maryse Brand and Marco Mosselman “Organizational Structure and Performance in Small Dutch Firms” (2005) 25 Small Business Economics 83 at 85.

<sup>36</sup> Meijaard, Brand and Mosselman, above n 35, at 85.

<sup>37</sup> Meijaard, Brand and Mosselman, above n 35, at 84.

substantial departmentalisation to be larger. These findings emphasise that the degree of complexity of organisational structure can be an important determinant of a large enterprise.

The existence of a strong positive correlation between a firm's size and the degree of its departmentalisation, as established by Meijaard, Brand and Mosselman,<sup>38</sup> perhaps indicates (with a high degree of caution), that organisational structure can be used as a qualitative criterion for large enterprises in New Zealand. This is, taking into account that the percentage of enterprises with more than 100 employees is merely 0.4% of the total number of enterprises in the country.<sup>39</sup>

### *3.3.2.2 Capital Structure*

Capital structure might serve as another criterion for describing a large enterprise. By the scale of their business operations large enterprises normally require a much larger capital to finance their ongoing operations, expansion and development. As we saw in section 3.2.2.1, large enterprises generally have a more complex and more developed organisational structure along with more employees. It would therefore be natural to assume that large enterprises possess not only a greater volume of capital, but also resort to more complex ways to finance their capital. However, is there evidence demonstrating that large enterprises have financial structures that are different from those of smaller firms? In other words, can capital structure be used as a characteristic of a large enterprise?

Prior studies in the area of capital structure indeed show that there are significant differences between the capital structure of large and small firms.<sup>40</sup> These differences can be attributed to factors such as barriers that small firms typically face in accessing external capital and the managerial ownership structure prevalent in small firms.<sup>41</sup>

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<sup>38</sup> Meijaard, Brand and Mosselman, above n 35, at 90 and 93.

<sup>39</sup> Statistics New Zealand, above n 10.

<sup>40</sup> Nirosha Wellalage and Stuart Locke "Capital Structure and Its Determinants in New Zealand Firms" (2013) 14 *Journal of Business Economics and Management* 852.

<sup>41</sup> Wellalage and Locke, above n 40.

A study undertaken by Cassar and Holmes<sup>42</sup> found positive results between a firm's size and level of debt. The greater level of debt in larger firms can be explained by their higher credit ratings which makes access to capital much easier for large enterprises. Large enterprises are more likely to have a higher level of debt in order to maximise tax benefits from debt.<sup>43</sup> In addition, according to Cassar,<sup>44</sup> small firms take on a lower level of borrowing compared to large firms due to the high transaction costs. Small firms tend to have managerial share ownership<sup>45</sup> and are more likely to use internal retained earnings to finance their investments rather than use debt or issue shares as equity.<sup>46</sup> In a study by Bhaird and Lucey<sup>47</sup> it was found that Irish SMEs have a lower level of external debt compared to larger firms. Furthermore, a negative relationship has been found between total level of debt and managerial ownership in small firms, implying that manager-owned firms tend to have a lower level of debt, as owner-managers are generally risk averse due to the "non-diversifiable employment risk".<sup>48</sup>

In a study of the top 50 listed companies in New Zealand, Wellalage and Locke<sup>49</sup> used time series data for the period from 2003 to 2009 to obtain 40 observations. The data set of the study revealed that the mean value of debt to assets ratio among listed New Zealand companies is 0.4, indicating a "high use of the corporate debt" in relation to equity by New Zealand listed companies.<sup>50</sup> Their study establishes that firm size is the most significant determinant of capital structure in New Zealand firms. The effect of firm size was found to be the most pronounced for firms with the smallest level of debt, and least pronounced for firms with the highest level

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<sup>42</sup> Gavin Cassar and Scott Holmes "Capital structure and financing of SMEs: Australian evidence" (2003) 43 *Accounting and Finance* 123.

<sup>43</sup> Raghuram Rajan and Luigi Zingales "What Do We Know About Capital Structure? Some Evidence from International Data" (1995) 50 *Journal of Finance* 1421.

<sup>44</sup> Gavin Cassar "The financing of business start-up" (2004) 19 *Journal of Business Venturing* 261.

<sup>45</sup> Timothy Brailsford, Barry Oliver and Sandra Pua "On the Relation between Ownership Structure and Capital Structure" (2002) 42 *Accounting and Finance* 1.

<sup>46</sup> Robert Watson and Nick Wilson "Small and Medium Size Enterprise Financing: A Note on Some of the Empirical Implications of a Pecking Order" (2002) 29 *Journal of Business Finance & Accounting* 557.

<sup>47</sup> Ciaran Bhaird and Brian Lucey "Determinants of Capital Structure in Irish SMEs" (2010) 35 *Small Business Economics* 1.

<sup>48</sup> Nirosha Wellalage and Stuart Locke "Impact of ownership structure on capital structure of New Zealand unlisted firms" (2015) 22 *Journal of Small Business and Enterprise Development* 127 at 135.

<sup>49</sup> Wellalage and Locke, above n 48.

<sup>50</sup> At 858.

of debt, implying that small firms in New Zealand rely more on the capital introduced by the owners. As the size of a firm grows, the ratio of the debt in its capital structure also increases.<sup>51</sup>

The findings of the studies outlined above indicate that the capital structure of large firms is different from that of smaller firms. Large enterprises in New Zealand might have higher level of debts, as SMEs are usually debt averse due to their managerial ownership. In addition, New Zealand SMEs finance their growth more with equity than with long-term borrowing. That is, small firms in New Zealand rely more on the initial capital introduced by manager-owners and retained earnings, rather than on the other sources of external finance. Due to the obvious differences in capital structure between small and large firms in New Zealand, as described above, it is perhaps possible to use capital structure as another criterion for defining large enterprises.

### *3.3.2.3 Geographical Span of Operations*

Do large enterprises generally operate in a wider market compared to SMEs? Do large enterprises tend to be more internationalised than SMEs? In other words, if an enterprise engages in export operations or carries out business activities internationally through branches or subsidiaries in foreign jurisdictions, is it more likely that this enterprise is large? The literature investigating the relationship between a firm's size and its propensity to export<sup>52</sup> finds that there is a significant positive relationship between a firm's size and its propensity to export. Thus, the larger the firm, the higher the likelihood that it will choose to engage in exporting. However, the fact that a particular enterprise engages in exporting does not automatically mean that this enterprise is large. Mittelstaedt, Harben and Ward estimated the export potential among US small, medium and large firms and found that the minimum size of US firms to have a potential for engaging in export activities is 20 employees.<sup>53</sup> This study showed that the probability of engaging in export operations generally increases with the increase in the size of

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<sup>51</sup> At 860.

<sup>52</sup> See, for example, John Mittelstaedt and William Ward "Location, Competition and Globalization: Increasing Returns and International Trade" (Centre for International Trade Working Paper 2-2003, 2003).

<sup>53</sup> John Mittelstaedt, George Harben and William Ward "How Small is Too Small? Firm Size as a Barrier to Exporting from the United States" (2003) 41 *Journal of Small Business Management* 68 at 72.

a firm measured by the number of employees.<sup>54</sup> The difference between the predicted and actual export activity was found to be the smallest for the category of large firms, implying that large US firms were indeed effectively exploiting their export potential.

There are a number of reasons why large firms are more likely to engage in export activities. First, integration into the global market requires exporters to meet standards of industrial certification, the costs of which might be prohibitive for small firms.<sup>55</sup> Second, non-tariff barriers (fixed transaction costs) affect both small and large firms to the same degree. However, these fixed costs impact on large firms in a smaller proportion than they impact on small firms. Large firms can more easily address these fixed transaction costs as they have sufficient resources for them. Third, large firms are more effectively organised for large scale export operations. Hodge and Anthony argue that as the size of a firm increases, the firm becomes more formalised and its task differentiation and specialisation also increases.<sup>56</sup> More developed organisational structures significantly help large firms to efficiently organise their export operations.<sup>57</sup>

The evidence in the literature that larger enterprises have a greater propensity to engage in export operations, does not, however, suggest that if a particular enterprise carries out export operations, then that enterprise is large. For example, among SMEs in New Zealand<sup>58</sup> approximately 33% were conducting export activities in 2011 according to a 2014 MBIE report.<sup>59</sup> While the number of enterprises engaged in export activities grew with an increase in the size of the organisation,<sup>60</sup> the report also indicated that a significant number of SMEs in New Zealand engage in export activities. Accordingly, if engagement in export activity cannot

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<sup>54</sup> Large firms were defined as firms with more than 500 employees, small-to-medium firms as firms with 100-499 employees and micro firms as firms with fewer than 20 employees. Mittelstaedt, Harben and Ward, above n 53, at 71.

<sup>55</sup> Mittelstaedt, Harben and Ward, above n 53, at 77.

<sup>56</sup> Billy Hodge and William Anthony *Organization theory: a strategic approach* (4th ed, Allyn and Bacon, Boston, 1991) at 26.

<sup>57</sup> Mittelstaedt, Harben and Ward, above n 53, at 80.

<sup>58</sup> Defined by MBIE as enterprises with a number of employees from 20-99. See MBIE, above n 5, at 10.

<sup>59</sup> MBIE, above n 5, at 46.

<sup>60</sup> 38% of enterprises with a number of employees equal or greater than 100 were conducting export activities. MBIE, above n 5, at 46.

serve as an indicator of a large enterprise activity, other features of a firm's internationalisation may serve as more reliable criteria.

One of the ways for a particular enterprise to operate globally is foreign direct investment (FDI), which can be implemented either through a wholly owned subsidiary, joint venture or contract manufacturing and distribution. In regard to the size of an enterprise which is more likely to implement its global operations through FDI, Skott-Kennel<sup>61</sup> finds that large enterprises<sup>62</sup> are more likely to enter global markets through FDI, while SMEs<sup>63</sup> in New Zealand rely more on networking and cooperation with foreign partners.<sup>64</sup>

Another study by Kinoshita<sup>65</sup> argues that small firms in Japan also invest in foreign markets through FDI. However, the pattern of their investment is different from that followed by large Japanese firms. While small Japanese firms are more likely to invest in markets with a cheap labour force and located in a close proximity to Japan, large firms prefer to invest in large markets.

The analysis of the literature in various jurisdictions on the relationship between a firm's size and its propensity to engage in export operations or invest in overseas markets through FDI, suggests that although there is a positive correlation, SMEs also engage in export activities and invest in foreign markets. This also seems to be true for New Zealand SMEs. However, the scale and pattern of both export operations and FDI is different for SMEs and large enterprises. Therefore, qualitative criterion, such as engagement in export operations and investing in overseas markets alone, are not effective in distinguishing between large enterprises and SMEs. Perhaps, with a help of numerical criteria such as an amount of export sales, value of worldwide assets and worldwide number of employees, it might be easier to separate large enterprises from SMEs.

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<sup>61</sup> Joanna Scott-Kennel "Models of internationalisation: the New Zealand experience" (2013) 10 *International Journal of Business and Globalisation* 105.

<sup>62</sup> Defined as enterprises which have over 300 employees worldwide. See Scott-Kennel, above n 61, at 115.

<sup>63</sup> Defined as enterprises which have up to 300 employees worldwide. See Scott-Kennel, above n 61, at 115.

<sup>64</sup> Scott-Kennel, above n 61, at 119.

<sup>65</sup> Yuko Kinoshita "Firm Size and Determinants of Foreign Direct Investment" (CERGE-EI Working Paper No. 135, 1998).

### *3.4. Conclusion*

As this chapter has demonstrated, defining large enterprises is a difficult task. The difficulty in arriving at a common definition is primarily due to the existence of many criteria and thresholds used to classify business entities in terms of their size. Types of criteria used to describe large enterprises in New Zealand were discussed. There are usually two types of criteria used to describe large enterprise: quantitative and qualitative.

Numerical criteria (quantitative criteria) usually operate with values such as the number of employees, turnover or assets value. Data on these variables can be easily obtained, are easy to understand and therefore convenient to use for comparing entities to determine, for example, their relative size. However, numerical criteria are established by various stakeholders (the tax authority, a government agency and other organisations which set rules for public entities' financial reporting), who have different objectives. Therefore these numerical criteria can differ significantly. This makes relying on a particular threshold as a benchmark in order to determine the size of an entity quite problematic. As noted earlier, the same entity might be considered large using the criteria set out in the FRA 2013, but at the same time this entity may fail to meet the threshold established by New Zealand's IR for determining large enterprises. Hence, when a particular enterprise is said to be large, the question arises as to by what standard is it large?

Since different benchmarks are used for quantitative criteria, qualitative criteria, which describe large enterprises on the basis of their intrinsic characteristics, might be helpful in setting large enterprises apart from SMEs and defining the true population of large enterprises in New Zealand. In this chapter three qualitative characteristics have been discussed: organisational structure, capital structure and geographical span of activity of business entity.

As indicated by previous studies, large enterprises tend to have more complex and more developed organisational structures compared to small firms. It has been shown that a firm's size is positively correlated with the degree of departmentalisation of the entity, implying that large enterprises need more employees possessing more narrow skills in order to manage such a complex structure efficiently. In regard to the second qualitative criterion examined in this chapter, capital structure, it was also shown that large entities, including New Zealand entities, tend to have more sources of external finance – either debt or equity – in their capital structure. Prior studies into the relationship between a firm's size and its propensity to export or engage in the worldwide business activity through FDI have shown to have a positive correlation, implying that larger firms are more likely to engage in export operations or invest in the

overseas markets through FDI. However, as evidenced in the literature and in a report by MBIE, SMEs in New Zealand also participate in export activities. SMEs in New Zealand also enter foreign markets, however unlike large enterprises they do so through cooperation with foreign partners.

The qualitative criteria discussed in this chapter might be helpful in determining the population of large enterprises in New Zealand in the following way. A minimum threshold of a business turnover<sup>66</sup> can be determined in each industry in accordance with industry benchmarks. A group of enterprises whose turnover meets this threshold can have its qualitative criteria (for example, organisational structure or capital structure) examined to see if the enterprises in this group exhibits the features of a large enterprise. These enterprises may have a matrix organisational structure and the prevalence of debt or equity in their financial structure. The presence of these qualitative criteria will imply that these enterprises are more likely to be large enterprises and not SMEs within this industry. As the turnover threshold increases the group of enterprises will become more homogenised in terms of these qualitative criteria. Empirical findings in the literature discussed in this chapter confirm this fact. Thus, examining enterprises in terms of their turnover and qualitative characterises can assist in determining a group of enterprises with features that very closely resemble large enterprises.

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<sup>66</sup> Gibson and van der Vaart, above n 19, at 14.



## **Chapter 4: Tax Compliance of Large Enterprises in New Zealand**

### *4.1 Introduction*

This chapter will present an outline of the tax compliance activities of large enterprises in New Zealand in order to provide an insight into the scope of the taxation matters that large enterprises operating in New Zealand have to deal with. It should be noted that the term enterprise in this chapter refers to an incorporated entity under the law of New Zealand or another jurisdiction and excludes general partnerships and trusts.<sup>1</sup> As discussed in Chapter 3 of this thesis, the concept of a large enterprise can be very complex as large enterprises may very often be not just a single enterprise, but a group of enterprises consolidated by a common parent. The situation becomes even more complicated in the case of a multinational group, where the ultimate parent is located offshore and the group is carrying on business activity in New Zealand through a permanent establishment (PE). In the case of a multinational group with a New Zealand or offshore parent, tax compliance in New Zealand may affect the whole group only partially. However, as discussed in this chapter, the New Zealand tax authority is becoming increasingly empowered with new legislation which allows it to impose additional compliance obligations on a multinational group which has a presence in New Zealand, either through a resident parent or PE.

A very crucial question arises as to what criterion should be applied in order to determine if a group of enterprises, especially a multinational group, is a large enterprise. In this chapter two criterion will be used. One is the NZ\$80 million Goods and Services Tax (GST) annual turnover threshold, which the Inland Revenue (IR) applies to define large enterprises.<sup>2</sup> Enterprises meeting this threshold are subject to a stricter compliance focus from the IR because in addition to being labelled “large” they are also classified as “significant enterprises”. Until recently, only enterprises with an annual GST turnover of greater than NZ\$80 million

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<sup>1</sup> Although a large enterprise can be formed as a general partnership of several groups of enterprises, for simplicity large enterprises are presented in this chapter either as a single entity or a group of incorporated entities with a common parent.

<sup>2</sup> As was mentioned in Chapter 3 of this thesis, the IR does not have an official definition of a “large enterprise” for the tax compliance purposes, but instead uses the term “significant enterprise”. From an interview with an IR tax official it was revealed that significant enterprises with a GST turnover greater than NZ\$80 million are considered as “large enterprises”. (Interview with an IR official, Tax Specialist, 10 April 2018, transcript provided by the researcher). Therefore, the NZ\$80 million threshold is used for purpose of this chapter to define large enterprise. A more detailed classification of “significant enterprises” will be provided in Chapter 6 of this thesis.

were classified as “significant enterprises”.<sup>3</sup> However, commencing from 2017, the IR has included foreign-owned enterprises with a greater than NZ\$30 million turnover in the category of significant.<sup>4</sup> Therefore, once a New Zealand enterprise’s annual turnover surpasses NZ\$80 million (NZ\$30 million for foreign-owned enterprise), such an enterprise comes under the IR’s “radar” and becomes classified as “significant”. Enterprises with this classification are likely to face greater tax compliance obligations as the IR focuses more closely on their business activity especially when significant enterprises engage in cross-border transactions. Thus, a single enterprise or a group of enterprises with an annual turnover of greater than NZ\$80 million is considered to be a large enterprise and a significant enterprise simultaneously.

Another criterion which will be used in this chapter is the criteria adopted from the Organisation for Economic Co-operation and Development (OECD) guidelines<sup>5</sup> on transfer pricing, which uses annual consolidated EURO750 million (NZ\$1.3 billion)<sup>6</sup> turnover as a threshold to define a multinational group of enterprises as a large multinational group. The OECD’s transfer pricing guidelines make it compulsory for such groups to provide additional information about their business activities worldwide and to file a country-by-country report (CbCR).<sup>7</sup>

Specifically, there are four types of large enterprises whose tax compliance obligations in New Zealand are discussed in this chapter. They are as follows:

1. An enterprise with an annual turnover over NZ\$80 million, which is a tax resident in New Zealand under one of the four tests provided in s YD 2 of the Income Tax Act 2007 (ITA 2007);
2. A group of enterprises with a consolidated annual turnover over NZ\$80 million, but up to NZ\$1.3 billion,<sup>8</sup> and a common parent, which is a tax resident in New Zealand under one of four tests provided in s YD 2 of Income Tax Act (ITA) 2007;

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<sup>3</sup> IR “Multinational Enterprises – compliance focus” (2016).

<sup>4</sup> IR, above n 3.

<sup>5</sup> OECD “Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations” (Paris, 2017).

<sup>6</sup> EURO-NZ\$ exchange rate (1 NZ\$ = 0.58 EURO). See IRD “Currency rates – rolling average” <<https://www.ird.govt.nz/resources/8/d/8de01e54-60d4-49ad-9e89-dd185007c345/mid-month-nov-2018.pdf>> (last accessed 29 December 2018).

<sup>7</sup> OECD, above n 5, at 242, [5.52].

<sup>8</sup> The IR threshold for large multinational groups.

3. A group of enterprises with a consolidated annual turnover over NZ\$80 million, but up to NZ\$1.3 billion,<sup>9</sup> whose ultimate parent is located outside New Zealand, but where at least one member of the group is a tax resident in New Zealand under one of four tests provided in s YD 2 of Income Tax Act (ITA) 2007. An annual turnover of this New Zealand resident–member must be above NZ\$80 million;
4. A large multinational group of enterprises, defined in s YA 1 of ITA 2007, whose ultimate parent is located either within or outside New Zealand.

The reason for using the above detailed definitions, as will be discussed further in this chapter, is that enterprises and groups of enterprises, which meet the above thresholds, are subject to a stricter compliance focus from the IR due to IR’s adoption of the Base Erosion and Profit Shifting (BEPS) Action Plan.<sup>10</sup>

The structure of the remainder of this chapter is as follows. Section 4.2 provides an overview of the topic of tax compliance of large enterprises in New Zealand, covering business income tax, pay as you earn (PAYE) tax, GST and Fringe Benefit Tax (FBT). In addition, aspects of cross border taxation including the taxation of controlled foreign companies (CFCs), foreign investment funds (FIFs) and thin capitalisation, are discussed. Section 4.3 further focuses on the tax compliance obligations of large multinational group enterprises undertaking business in New Zealand. Due to a stricter screening from the IR of large multinational groups, and the growing presence of large multinational groups in New Zealand, an understanding of the features of tax compliance for multinationals in New Zealand is considered both important and relevant. Lastly, section 4.4 provides a chapter summary.

#### *4.2 Overview of Tax Compliance of Large Enterprises in New Zealand*

New Zealand features a relatively simple, broad base low rate (BBLR) tax system.<sup>11</sup> A BBLR system improves economic efficiency by “reducing the distortions to economic decision-

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<sup>9</sup> The IR threshold for large multinational groups.

<sup>10</sup> The BEPS Action Plan has been devised by the OECD in order to combat tax evasion by large multinational enterprises and is currently being adopted in New Zealand. See IR “Base erosion and profit shifting (BEPS) – update on the New Zealand work programme” (May 2016).

<sup>11</sup> IR “The New Zealand tax system and how it compares internationally” (2017).

making caused by taxes”.<sup>12</sup> The main feature of a BBLR system lies in the introduction of a broad base of taxation while keeping tax rates low.<sup>13</sup> Thus, personal tax, income tax and consumption tax form three broad bases which provide for the majority of tax revenue in New Zealand.<sup>14</sup> By implementing a BBLR system, New Zealand aims at maintaining a “simple, easily understandable and coherent framework”, which results in the consistent taxation of different areas of economy, thereby reducing economic distortions.<sup>15</sup>

As result, the country’s tax system ranks very highly according to the 2017 International Tax Competitiveness Index Rankings. With an overall score of 88.7, New Zealand ranks second in the world by the simplicity of its tax system.<sup>16</sup> The simplicity of the New Zealand tax system can be explained by the existence of a relatively small number of taxes<sup>17</sup> and a small number of tax payments and exemptions used when calculating income tax. This makes tax compliance in New Zealand relatively simple and less burdensome. New Zealand corporate tax complexity ranks second in the International Tax Competitiveness Index 2017.<sup>18</sup>

In this subsection an outline of the major business taxes that all incorporated entities, including large enterprises, deal with, will be provided along with information on compliance associated with these taxes. It should be noted that the tax compliance procedures presented below apply to large enterprises incorporated in New Zealand and to large multinational enterprises which have a presence in New Zealand through a PE, such as a branch, or have a subsidiary in New Zealand.

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<sup>12</sup> Adrian Sawyer “Reflections on the contributions of lawyers to tax policy-making in New Zealand”, (2017) 27(4A) New Zealand Universities Law Review, 995-1022.

<sup>13</sup> At 9.

<sup>14</sup> At 9.

<sup>15</sup> At 10.

<sup>16</sup> Kyle Pomerleau, Scott Hodge and Jared Walczak “International Tax Competitiveness Index 2017” (Tax Foundation, 2017) at 3.

<sup>17</sup> New Zealand does not have capital gain tax, social security taxes, inheritance tax and local taxes.

<sup>18</sup> Pomerleau, Hodge and Walczak, above n 16, at 3.

#### 4.2.1 Business Income Tax

All New Zealand incorporated enterprises and overseas enterprises operating in New Zealand through a PE must pay tax on their profits, known as business income tax. The corporate tax rate in New Zealand is a flat rate of 28%. The tax rate is the same for small businesses as for large multinational enterprises operating in New Zealand. Taxable profit is derived by deducting expenses from revenue in accordance with the ITA 2007. While most types of revenue are taxable (except those of capital nature), the ITA 2007 qualifies business expenditures as deductible if one of the following two premises is satisfied:

1. There must be a nexus between the expenditure or loss and the derivation of business income;<sup>19</sup>
2. The expenditure arises in the course of carrying on a business.<sup>20</sup>

The timing of the expenditure deduction is determined based on when the particular expenditure is incurred.<sup>21</sup> Therefore, an accrual basis approach is generally used to determine the timing of a deduction. Expenditures which remain unexpired at the end of tax year must be included as income<sup>22</sup> which means they are not deductible until consumed. Expenditure of capital nature must be capitalised first and then expensed over a certain period of time through depreciation at the rates established by the IR. One exception to the capital expenditure depreciation rule is that the depreciation rate for buildings in New Zealand with an estimated useful life over 50 years is 0%.<sup>23</sup>

Tax compliance for enterprises in relation to business income tax begins with the collection and recording of information about business transactions, as the derivation of taxable income requires the preparation of financial statements. In this regard, the IR prescribes that large enterprises in New Zealand must prepare financial statements in accordance with higher standards of accounting mandated by the External Reporting board (XRB).<sup>24</sup> Large enterprises

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<sup>19</sup> Income Tax Act 2017 [ITA 2007], s DA 1(1)(a).

<sup>20</sup> ITA 2007, s DA 1(1)(b).

<sup>21</sup> ITA 2007, s BD 4.

<sup>22</sup> James Coleman and others *New Zealand Taxation 2018: Principles, Cases and Questions* (Thomson Reuters, Wellington, 2017) at 314.

<sup>23</sup> ITA 2007, s EE 31(2)(d).

<sup>24</sup> IR “Financial reporting for companies” <<https://www.ird.govt.nz/yoursituation-bus/running/recordkeeping/financial-reports.html>> (last accessed 24 January 2019).

that have public accountability (also referred to as “reporting entities”)<sup>25</sup> must prepare their financial statements in accordance with generally accepted accounting practice (GAAP).<sup>26</sup> The XRB prescribes the application of the New Zealand equivalents to International Financial Reporting Standards (NZ IFRS) as GAAP for large enterprises with public accountability.<sup>27</sup> Large enterprises which are not reporting entities in accordance with the requirements of Financial Markets Conduct Act 2013 must still prepare GAAP financial statements as required by the Financial Reporting Act 2013 (FRA 2013).<sup>28</sup> In the case of non-reporting large enterprises, the XRB prescribes the use of NZ IFRS with reduced disclosure requirements.<sup>29</sup> It should be noted that the status of a large enterprise is determined in this case not by IR criteria, but by the large enterprises criteria established in the FRA 2013.<sup>30</sup> An enterprise is considered to be large under the FRA 2013 if:

(a) as at the balance date of each of the 2 preceding accounting periods, the total assets of the entity and its subsidiaries (if any) exceed \$60 million,<sup>31</sup>

(b) in each of the 2 preceding accounting periods, the total revenue of the entity and its subsidiaries (if any) exceeds \$30 million.<sup>32</sup>

As indicated above, the thresholds used in the FRA 2013 to define large enterprises are well below NZ\$80 million turnover established by the IR. Therefore, those enterprises that fail to reach the IR threshold (and thus, be classified as large) nevertheless will have to prepare IFRS-based financial statements which are also provided to the IR.

Because of the requirement to prepare IFRS-based financial statements, enterprises (both large by the IR definition and by the definition provided in the FRA 2013) are likely to be subject to more compliance as they will have to consider temporary and permanent differences in their financial statements. A temporary difference can be, for example, the differences between the

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<sup>25</sup> Defined in s 7 of XRB Standard A1: “Application of the Accounting Standards Framework”.

<sup>26</sup> Financial Markets Conduct Act 2013, s 460(1).

<sup>27</sup> XRB A1: “Application of the Accounting Standards Framework”, paras 17(a)(i) and 22.

<sup>28</sup> Financial Reporting (Amendments to Other Enactments) Act 2013, ss 200 and 201.

<sup>29</sup> XRB Standard A1: “Application of the Accounting Standards Framework”, paras 20(a) and s 23.

<sup>30</sup> Financial Reporting Act 2013 [FRA 2013], s 45(1)(a).

<sup>31</sup> FRA 2013, s 45(1)(a).

<sup>32</sup> FRA 2013, s 45(1)(b).

depreciation rates utilised by a large enterprise in financial reporting, which are determined by a useful period of an asset, and the depreciation rates established by the IR. The deductibility of only 50% of entertainment expenses for income tax purposes<sup>33</sup> and the full deduction of these for financial reporting creates a permanent difference.

For business income tax, all resident enterprises, large and small, need to file a tax form, IR4, and attach either financial statements with adjustments required for the derivation of taxable income, or special a form, IR10 (Accounts Information Form), which includes balances of accounts. When an enterprise is a resident company,<sup>34</sup> worldwide income must be returned on the form IR4,<sup>35</sup> whereas non-resident enterprises would include only New Zealand-sourced income in IR4.<sup>36</sup> Filing an IR4 should not be a difficult task provided all the necessary information is collected and available as the format of an IR4 form is relatively straightforward. The most difficult task in filing an IR4 is to collect and process the necessary information so that all questions in the IR4 relevant to an enterprise's business activity can be accurately filled out. For example, Question 18 "Overseas Income" in the IR4 requires entering information related to the overseas income of an enterprise. Overseas income may include attributed income from a Controlled Foreign Company (CFC) and income from a Foreign Investment Fund (FIF). The calculation of income from both CFC and FIF is rather complex and requires special knowledge of cross border tax regulation. This illustrates that it is not the preparation of the tax form (IR4) that increases the compliance burden, but rather the collection and processing of the information required for filling out the IR4.

The package of tax information that an enterprise is required to submit also includes information about the balance of imputation credit account. Form IR4J is used for reporting information on the imputation credit account (ICA). The ICA represents the balance of income taxes paid by an enterprise during an imputation year (a year which runs from 1 April to 31 March) and imputation credits attached to dividends received from other enterprises. The IR uses this form to monitor the balance of the ICA. If the ICA shows debit balance at the tax

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<sup>33</sup> ITA 2007, s DD 1(2).

<sup>34</sup> Defined in ITA 2007, s YD2.

<sup>35</sup> Coleman and others, above n 22, at 604.

<sup>36</sup> Most non-resident enterprises would have to return New Zealand sourced income if the enterprise has a PE in New Zealand.

year-end, the enterprise will have to pay the debit balance along with 10% of the so-called additional tax on the debit balance by 20 June of the relevant year.<sup>37</sup>

The Tax Administration Order 2014 requires tax-filing entities to disclose information related to transactions with associated persons, the meaning of which is defined in ITA 2007. Specifically, entities are required to provide information regarding the following matters:<sup>38</sup>

- (a) interest expense incurred by the company in respect of any loan made to the company by the associated person; and
- (b) amounts paid by the company to the associated person in the nature of outbound loans or other advances; and
- (c) expenses incurred by the company for services provided by the associated person (including wages, salaries, management fees, and payments for other services provided to the company); and
- (d) expenses incurred by the company to the associated person in respect of rentals or leases of land or other assets; and
- (e) expenses incurred by the company to the associated person for acquiring or using intangible property, including royalty payments; and
- (f) a reconciliation of movements in shareholders' equity and loans or current accounts to, and from, the shareholders or other owners of the company and associated persons of the company.

If an enterprise incurs tax losses, then there can be two ways to utilise these losses. The first is to carry forward the tax loss in order to offset it against taxable income in the next period or periods. To be able to carry forward losses a company must maintain at least 49% of ownership (shareholder continuity). Shareholder continuity must be maintained from the time the tax losses were derived until when they are utilised.<sup>39</sup> The second way to utilise tax losses is to offset them against taxable income within a group of enterprises. Two or more enterprises can form a group for the purpose of utilising the tax losses of one or more enterprises in the group

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<sup>37</sup> ITA 2007, s OB 65.

<sup>38</sup> Tax Administration (Financial Statements) Order 2014, sch. 3.

<sup>39</sup> ITA 2007, s IA 5(6).



if there is at least a 66% common shareholding between enterprises in a group<sup>40</sup> This 66% commonality of ownership must be in existence when the loss occurred and continue to exist until the tax loss is offset.<sup>41</sup>

The percentage of shareholder continuity is measured by taking the lowest voting or market value interest held by each shareholder during the continuity period. If the sum of the lowest voting percentages is below 49% then there is a breach of shareholder continuity and the enterprise's losses cannot be carried over.<sup>42</sup> The same principle of calculating the lowest common voting or market value interest applies to company grouping losses.<sup>43</sup>

Considering that large enterprises generally have a complex structure and therefore, have more transactions with associated persons, large enterprises may need to provide additional information regarding transactions with those associated persons. This is especially true in the case of cross-border transactions with associated persons. In such cases, large enterprises have to deal with the transfer pricing regime and prepare documentation in order to prove the existence and use of an arm's length price. Preparation of additional documentation is likely to increase compliance.

As mentioned in section 4.1, large enterprises might have a complex structure where a number of smaller entities form a large group. In the case of 100% common ownership, a number of entities can form a tax group for tax filing and therefore file tax returns as if this group of entities were a single company. Consolidation allows the offsetting of tax losses incurred by entities in a group against the taxable income of other entities in the same group. However, only "eligible" companies, defined in s FM 31(1) of the ITA 2007 can form a consolidated group and appoint a nominated company or agent for filing tax returns on behalf of the group. Election to form a consolidated group is done by submitting form IR 494. All dividends are distributed tax-free within a consolidated tax group (also known as the intercorporate dividend exemption).<sup>44</sup> Such an exemption relieves companies inside the group from the obligation to

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<sup>40</sup> ITA 2007, s IC 3(1).

<sup>41</sup> ITA 2007, s IC 2(2).

<sup>42</sup> See Example 12.2 in Coleman and others, above n 22, at 441.

<sup>43</sup> At 443.

<sup>44</sup> See IR "Loss grouping and imputation credits: An officials' issues paper" (2015) at ch 2.

file information related to the ICA. Although as a whole, the group may need to provide the balances in the group's ICA.<sup>45</sup>

In addition to the obligation of calculating and filing business income tax returns, another obligation of an enterprise in regard to business income tax is to estimate and pay provisional tax during the tax year. An enterprise is required to pay provisional tax if it meets the requirements set out in s RC 3 of the ITA 2007,<sup>46</sup> and is referred to as a "provisional taxpayer". An enterprise must pay its provisional tax usually in three instalments during the tax year according to the rules set out in subpart RC of the ITA 2007. Provisional tax is an estimation of the amount of actual tax that will be payable by an enterprise for a particular tax year and is credited against the tax liability for that year.<sup>47</sup> An enterprise is required to pay provisional tax when residual income tax (defined in s YA 1 of the ITA 2007), of that enterprise is more than NZ\$2,500.

Provisional tax payments must be aligned with payments of GST if an enterprise is registered for GST. Every large enterprise is most likely to be registered for GST as (by definition) its turnover will surpass the threshold of NZ\$60,000, which makes filing and payment of GST obligatory. As discussed in section 4.2.3 below, enterprises with an annual turnover greater than NZ\$24 million must file GST returns on a monthly basis. Enterprises which are required to file monthly GST returns must pay their provisional tax in three instalments.

The failure to pay provisional tax on time will entail late payment penalty under the Tax Administration Act 1994 (TAA 1994)<sup>48</sup> and the use-of-money interest which is levied on the underpaid amount of provisional tax due.<sup>49</sup>

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<sup>45</sup> Despite the ITA 2007 allowing enterprises with 100% common ownership consolidating for tax purposes, in practice consolidation of enterprises for tax purposes is a rare phenomenon in New Zealand.

<sup>46</sup> Coleman and others, above n 22, at 551.

<sup>47</sup> At 551.

<sup>48</sup> Tax Administration Act 1994 [TAA 1994], s 139B(2).

<sup>49</sup> TAA 1994, ss 120A-120V.

#### *4.2.2 Pay as You Earn Tax and Resident Withholding Tax*

Another important aspect of tax compliance for every entity, including large enterprises, which conducts business operations in New Zealand, is an obligation to withhold tax from other persons on their behalf with subsequent reporting and payment of the withheld tax to IR.<sup>50</sup> The main types of income, which require the withholding of tax, are:

- Employment income (salary and wages);
- Scheduler payments (payments made to self-employed taxpayers);
- Superannuation contributions made by an employer;
- Interest; and
- Dividends.

An enterprise, large or small, must deduct “pay as you earn” (PAYE) tax from salaries and wages that it pays to its employees. PAYE is also deducted from payments made by an enterprise to self-employed taxpayers who provide certain services for the enterprise during a contractually agreed period. The difference between PAYE deducted from the salaries of employees and PAYE withheld from payments (schedular payments)<sup>51</sup> to self-employed individuals is the percentage of tax being deducted. PAYE tax constitutes an important source of revenue for the IR as PAYE constitutes almost 44.5% of the IR’s revenue.<sup>52</sup> Due to its importance as a source of revenue, the IR requires enterprises to comply with their duties as tax agents for their employees. One of the duties of an enterprise as a tax agent is to collect deducted tax and make a payment to IR. Each payment must be accompanied by a PAYE payment form which is completed on special form called an Employer Deductions Form (Form IR345).<sup>53</sup> Information about gross salaries and wages and the corresponding tax deducted is submitted on the Form IR348 (employer monthly schedule).

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<sup>50</sup> Coleman and others, above n 22, at 522.

<sup>51</sup> The list of scheduler income types is provided in Schedule 4 of the ITA 2007.

<sup>52</sup> IR “Revenue collected 2008 to 2017” <<https://www.ird.govt.nz/aboutir/external-stats/revenue-refunds/revenue-collected/revenue-collected.html>> (last accessed 1 January 2019). Average percentage is the researcher’s own calculations.

<sup>53</sup> Coleman and others, above n 22, at 535.

In order to reduce the amount of tax compliance, the IR designates two types of employers - large and small. Large employers are defined as those employers whose gross PAYE deduction exceeds NZ\$500,000 for the preceding tax year<sup>54</sup> and therefore are required to account for PAYE deductions twice a month. In addition, large employers are required to file their employer monthly schedule in electronic format.<sup>55</sup>

As a part of the Business Transformation Programme, a multi-stage programme aimed at modernising New Zealand's tax system by 2021,<sup>56</sup> for the tax years commencing from 1 April 2019 under proposed changes by Parliament,<sup>57</sup> PAYE filing will be integrated with the payroll-system which enterprises use to calculate and pay salaries to their employees. Therefore PAYE information will be filled to the IR on each payday directly from the payroll system. Large enterprises, for which electronic filing of PAYE information is obligatory,<sup>58</sup> will be required to send PAYE information by the second working day after payday. As a result, the previously filed IR345 and IR348 forms will no longer be required.

As a payer of certain kinds of passive income to New Zealand tax residents (such as interest and dividends) every enterprise, include a large enterprise, must withhold tax under the Resident Withholding Tax (RWT) rules.<sup>59</sup> It should be noted that only those enterprises which are resident <sup>60</sup>in New Zealand or if non-resident and carry on their taxable activity in New Zealand through a PE, are liable to deduct RWT.<sup>61</sup> However, there are two exceptions. First, there is no need to deduct RWT if the recipient of interest or dividends has an exemption certificate which is issued by IR to persons who are not liable for income tax (for example,

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<sup>54</sup> ITA 2007, ss RD 4(1) and RD 22.

<sup>55</sup> Coleman and others, above n 22, at 537.

<sup>56</sup> For further information, see IR "Transforming Inland Revenue" <<https://www.ird.govt.nz/transformation/bt-programme/stages/bt-programme-stages.html>> (last accessed 25 January 2019).

<sup>57</sup> See Taxation (Annual Rates for 2017-18, Employment and Investment Income, and Remedial Matters) Bill 2017.

<sup>58</sup> Enterprises with an annual PAYE of NZ\$50,000 and above. See IRD "PAYE reporting - Better administration of PAYE" (2016).

<sup>59</sup> ITA 2007, s BE 1(2).

<sup>60</sup> Defined in s YD 2 of the ITA 2007.

<sup>61</sup> ITA 2007, s RE 4.

charities). Second, if the amount of the interest payments made by an enterprise during the year is less than NZ\$5,000 then the enterprise is not required to withhold RWT.<sup>62</sup>

Apart from the obligation, if it arises, to deduct RWT when an enterprise (including a large enterprise) pays interest or dividends, it is also necessary to report and pay the withheld RWT to the IR. Large enterprises must remit the deducted RWT to the IR on a monthly basis by the 20th day of the following month.<sup>63</sup> As for reporting on amounts of withheld RWT (on either interest or dividends), a large enterprise must prepare RWT deduction certificates for persons whom the large enterprise has made payments of interest or dividends during tax year. This certificate must show the gross amounts of interest or dividend payments made, dates on which payments were made and the rate at which RWT was deducted.<sup>64</sup> Another type of compliance concerning RWT is the requirement to complete a reconciliation statement (IR 15S), which must be furnished to IR by 31 March. This form must be submitted by every enterprise which is required to deduct RWT.<sup>65</sup> This form contains information on each recipient (of interest or dividends), including the recipient's tax number, address and the date the deduction was made.<sup>66</sup>

#### *4.2.3 Goods and Services Tax*

Goods and Services Tax (GST) is an indirect consumption tax which is charged on all taxable supplies of goods and services made by an enterprise. A very important aspect here is that GST is levied only on those goods and services which are supplied in New Zealand or are exported. GST can be levied on imported goods too. GST is levied on the value of imported goods which includes the cost of insurance and freight, custom value for duty purposes, amount of custom duty and taxes other than GST.<sup>67</sup> In addition, from 1 October 2016 GST applies to remote

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<sup>62</sup> ITA 2007, s RE 10.

<sup>63</sup> ITA 2007, ss RE 21(2) and RA 15(2).

<sup>64</sup> TAA 1994, s 25.

<sup>65</sup> TAA 1994, s 51.

<sup>66</sup> IR *IR15S: RWT on interest reconciliation statement* (March 2017).

<sup>67</sup> Goods and Services Tax Act 1985 [GSTA 1985], s 12.

services<sup>68</sup> supplied by non-residents from overseas to New Zealand consumers. Furthermore, from 1 October 2019 GST will be levied on the low value imported goods (valued at or below NZ\$1,000) which are purchased by New Zealand consumers through an electronic marketplace.<sup>69</sup> Newly enacted rules will make it compulsory for overseas suppliers of low valued goods to register with the IR and pay GST on their supplies if their turnover exceeds NZ\$60,000 and goods are supplied to New Zealand consumers who are not GST registered.<sup>70</sup>

The GST system in New Zealand permits few exceptions, it is widely recognised for its simplicity and relative easiness to comprehend.<sup>71</sup> To explain briefly, GST operates in the following way. When good and services are sold in New Zealand their sale price includes GST at the rate of 15%. Only those entities which are registered for GST charge GST on the sale price of their goods and services. An entity which charges GST must account for it to the IR but at the same time can offset the GST charged on the sales price with the GST included in the price of expenditures that this entity incurred in the course of undertaking a supply of goods and services.

Some supplies are exempted from GST, while others are zero-rated. Examples of GST exempt supplies listed under s 14 of the Goods and Services Tax Act 1985 (GSTA 1985) include:

- Financial services;
- Donated goods and services by non-profit bodies;
- Supply of residential accommodation; and
- Fine metals, which are not zero-rated.

Examples of zero rated supplies under s 11 of the GSTA 1985 include:

- Exported goods;
- Duty-free goods;
- Boats and aircrafts exported under their own power;

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<sup>68</sup> The definition of remote services includes digital services such as e-books, music, video and software. Non-digital services include consulting, legal and accounting services. See IR “GST on cross-border supplies of remote service” (May 2016).

<sup>69</sup> See s 2(1) of the GSTA 1985 for the definition of “electronic marketplace”. See also Taxation (Annual Rates for 2019–20, GST Offshore Supplier Registration, and Remedial Matters) Bill 2018 (explanatory note).

<sup>70</sup> See Taxation (Annual Rates for 2019–20, GST Offshore Supplier Registration, and Remedial Matters) Bill 2018 (explanatory note).

<sup>71</sup> Coleman and others, above n 22, at 872.

- Taxable activities sold as going concerns to GST registered persons;
- Supply of land by one registered person to another registered person who intends to use the land for making taxable supplies; and
- International transportation of passengers, goods and associated services.

The difference between exempt and zero-rated supplies is that for exempt supplies, no GST can be claimed on expenditures incurred, whereas in the case of zero-rated supplies, GST can be claimed on expenditures associated with these supplies and is charged at zero percent on supplies made.

An obligation to register for GST applies equally to resident and non-resident entities.<sup>72</sup> The requirement for an entity to register for GST arises when the value of taxable supplies of that particular entity exceeds NZ\$60,000 for any 12 month period.<sup>73</sup> If an entity which is liable to register for GST fails to do so by the required date it will be automatically deemed to be registered with effect that it cannot avoid its obligation to collect and pay GST on its supplies.<sup>74</sup> Entities liable to register for GST must do so within 21 days after the end of the 12 month period in which the NZ\$ 60,000 threshold was exceeded, or at the start of the 12 month period in which this threshold is expected to be surpassed.<sup>75</sup> Needless to say, large enterprises, which supply goods and services in New Zealand or remote services from overseas to New Zealand consumers, must be registered for GST as their turnover threshold surpasses the GST registration threshold.

If an enterprise, including a large enterprise, is registered for GST and carries on its business operations in New Zealand through branches, this enterprise may have some or all of the branches registered for GST if those branches have own accounting system and have different locations within New Zealand.<sup>76</sup> The NZ\$60,000 threshold applies to all the branches and not to a single branch.<sup>77</sup> Separate registration allows each registered branch to be accountable for its GST on supplies of goods and services. Goods and services supplied between the parent and

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<sup>72</sup> GSTA 1985, s 51(3).

<sup>73</sup> GSTA 1985, s 51(1).

<sup>74</sup> Coleman and others, above n 22, at 877.

<sup>75</sup> GSTA 1985, s 51 (2).

<sup>76</sup> GSTA 1985, s 56.

<sup>77</sup> Coleman and others, above n 22, at 880.

branches are GST taxable also. If a branch fails to furnish its GST report or pay GST, then the parent will be responsible for the submission of the GST return and the payment of GST due.

Large enterprises often represent not just a single entity, but also a group of entities which have a common parent-entity. If this group of entities can form a group for filing a consolidated tax return<sup>78</sup> (discussed earlier in this chapter), then these entities can apply for GST registration as a single group.<sup>79</sup> However, in addition to meeting the conditions required for filing a consolidated income tax return, one of the following conditions must also be satisfied:

- Each of the entities in the group must be registered for GST; or
- At least 75% of total supplies made by the entities in the group to a third party are taxable supplies.<sup>80</sup>

Group registration allows all entities to be treated as a single entity for GST purposes and file one GST return. Accordingly, all transactions within the group are ignored for GST purposes.<sup>81</sup>

Large enterprises must account for GST on a monthly basis. This requirement is stipulated in s 15(3) of the GSTA 1985 which prescribes that entities whose turnover has been greater than NZ\$24 million in the past 12 months or is expected to exceed NZ\$24 million in the next 12 months, must file a GST tax return every month.<sup>82</sup> If a large enterprise has branches and these branches file separate GST returns, then they also must file on a monthly basis if the parent enterprise is required to file on a monthly period.

There are three methods used to account for GST:<sup>83</sup>

- Invoice basis;
- Payment basis; and
- Hybrid basis.

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<sup>78</sup> ITA 2007, s FM 31(1).

<sup>79</sup> GSTA 1985, s 55 (1)(a).

<sup>80</sup> Taxable supplies are supplies to which GST applies and are carried on continuously by GST registered entity. See GSTA 1985, s 55 (1)(b).

<sup>81</sup> Coleman and others, above n 22, at 881.

<sup>82</sup> GSTA 1985, s 15(3).

<sup>83</sup> GSTA 1985, s 19.



Large enterprises must use the invoice basis to account for GST as the other two methods can be used by enterprises whose taxable supplies during last 12 months have not exceeded NZ\$2 million.<sup>84</sup> For large enterprises, the requirement to account for GST on an invoice basis means that the GST amounts indicated on invoices issued by large enterprise must be paid prior to the collection of cash. Likewise, GST on expenses incurred during GST filing period (a month) can be claimed as a deduction prior to cash disbursement.

The basic approach to the calculation of GST payable or refundable is to deduct from the GST collected on supplies (output GST), the GST paid on expenditures (input GST). A positive result means that GST is payable, otherwise GST is refundable. It is necessary to hold tax invoices for the deduction of input GST, except for low value supplies of less than NZ\$50.<sup>85</sup> However, the amount of input GST that can be claimed as a deduction depends on the percentage of expenditures used for making taxable supplies. Since some supplies may be GST exempt, GST on expenditures used in making exempt supplies cannot be deducted and therefore must be apportioned between GST taxable supplies and GST exempt supplies according to the formula provided in the GSTA 1985.<sup>86</sup> Due to the large scale of operations and substantial expenditures of head offices, large enterprises may incur significant compliance costs in regard to apportionment of input GST between taxable and exempt supplies.

The difficulty which large enterprises in New Zealand have to deal with when complying with the requirements of the GSTA 1985 to apportion input GST can be further illustrated with an example on retirement villages.<sup>87</sup> Retirement villages provide a range of services such as accommodation, cleaning, nursing or medical services. Part of the accommodation that retirement villages provide to their clients falls under the definition of a “residential dwelling” and is therefore a GST exempt supply.<sup>88</sup> However, another part of the accommodation supplied might be provided along with cleaning and medical services and accordingly pertains to a “commercial dwelling”,<sup>89</sup> the supply of which is GST taxable. As a retirement village incurs a number of expenses to operate village facilities, it is necessary to apportion these expenses

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<sup>84</sup> GSTA 1985, s 19A(1)(b)(i).

<sup>85</sup> GSTA 1985, s 24(5)(a).

<sup>86</sup> GSTA 1985, s 20C and 20G.

<sup>87</sup> See IRD “GST – Current issues: An officials’ issues paper” (2015) at ch 3.

<sup>88</sup> GSTA 1985, s 14(1)(c), (ca).

<sup>89</sup> Defined in s 2 of the GSTA 1985.

between exempt and non-exempt supplies. The apportionment leads to significant compliance costs<sup>90</sup> as it becomes necessary to determine multiple apportionment rates, which must be applied to every expense and tracked. For example, expenses of the head office may relate to the entire business activity (which may include multiple villages), while other costs may relate to a specific village or part of a village and therefore the proportion of taxable/non-taxable supplies may differ.<sup>91</sup>

GST payable for the tax period must be remitted to the IR on or before the due date for filing GST return.<sup>92</sup> As a rule, it is the 28th day of the month following the end of the tax period.<sup>93</sup> The amount of GST indicated in the return is the amount that must be paid to the IR unless the IR challenges the amount or issues a reassessment.<sup>94</sup>

#### *4.2.4 Fringe Benefit Tax*

In New Zealand, Fringe Benefit Tax (FBT) is a tax levied on an entity for the non-monetary benefits provided by it to its employees in connection with their employment. Such benefits may include:

- an entity's motor vehicle provided to employees for their private use;<sup>95</sup>
- loans provided by an entity to an employee;<sup>96</sup>
- subsidised transport;<sup>97</sup>
- contributions to life or health insurance;<sup>98</sup> and
- unclassified benefits.<sup>99</sup>

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<sup>90</sup> IRD, above n 86.

<sup>91</sup> IRD, above n 86.

<sup>92</sup> GSTA 1985, s 23.

<sup>93</sup> GSTA 1985, s 23(1) and s 16.

<sup>94</sup> Coleman and others, above n 22, at 927.

<sup>95</sup> ITA 2007, s CX 6(1).

<sup>96</sup> ITA 2007, s CX 10(1).

<sup>97</sup> ITA 2007, s CX 9.

<sup>98</sup> ITA 2007, s CX 16(5).

<sup>99</sup> ITA 2007, ss CX 2(1)(b)(ii) and CX 37.

Due to the availability of resources, large enterprises are more likely to provide a number of such benefits to their employees as a part of an attractive remuneration package. Large enterprises may offer loans to their directors and senior managers and offer attractive health plans and life insurance to their employees. Some benefits, not mentioned above, are unclassified fringe benefits, if they are provided by an enterprise to its employees in connection with their employment and are not excluded fringe benefits.<sup>100</sup> Unclassified benefits may include: free or discounted goods,<sup>101</sup> and free or discounted services.<sup>102</sup>

An example of a free or discounted service can be free travel offered by large enterprises to their expatriates seconded to work overseas. A large enterprise may provide free or subsidised return overseas travel for its seconded employees. This situation, when expatriate employees are offered such a fringe benefit can apply to large enterprises with an overseas head office and branches or subsidiaries in New Zealand as well as to large New Zealand enterprises with overseas branches or subsidiaries.

However, the taxation of fringe benefits offered to employees of large enterprises may depend on several factors. Benefits provided in New Zealand to employees of non-resident large enterprises may not be subject to fringe benefit tax if employees do not receive a PAYE income payment that is taxable in New Zealand.<sup>103</sup> By way of contrast, fringe benefits offered to an employee of a non-resident large enterprise who receives a PAYE income which is taxable in New Zealand will be subject to FBT in New Zealand. Finally, when non-resident employees PAYE income payments are exempt from tax in New Zealand by either the ITA 2007 or a relevant double tax agreement (DTA), any fringe benefits provided to that employee do not attract FBT.

In situations when a large enterprise with a head office in New Zealand provides fringe benefits to employees employed in overseas branches, the taxation of these fringe benefits is determined again, by whether the overseas branch employees receive a PAYE income which is taxable in New Zealand. Therefore, fringe benefits offered to employees of a New Zealand large

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<sup>100</sup> ITA 2007, s CX 37.

<sup>101</sup> ITA 2007, s RD 40.

<sup>102</sup> ITA 2007, s RD 41

<sup>103</sup> ITA 2007, s CX 26.

enterprise who are stationed in overseas branches are not subject to FBT if the employees PAYE income is not taxable in New Zealand.<sup>104</sup>

Filing and payment of FBT by large enterprises is undertaken on a quarterly basis by completing the form IR420. There are two FBT rates available to large enterprises (as well as to any other enterprise that opts to file on a quarterly basis):<sup>105</sup>

- Single rate of 49.25% of the value of all fringe benefits in each of the four quarters of the tax year.
- Single rate of 49.25% in the first three quarters and alternate rate in the fourth quarter of the tax year.

Under the alternate rate option a large enterprise may choose to pay FBT at the rate of 43% on the value of all fringe benefits offered to employees in the first three quarters. A rate of 49.25% must be used if the rate of 43% is not applied in any of the first three quarters. In the fourth quarter a detailed calculation of FBT is required, which involves square-up calculations and the attribution of fringe benefits to particular employees.<sup>106</sup>

Large enterprises are more likely to have to pay FBT on a quarterly basis. As mentioned in section 5.1 of this chapter, large enterprises are those entities whose annual turnover exceeds NZ\$80 million. FBT quarterly payments are required when total PAYE in the previous tax year exceeds NZ\$1million.<sup>107</sup> PAYE deductions exceeding NZ\$1million correspond approximately to NZ\$3.3 million of wages and salaries paid to employees during the tax year. This approximation can be obtained by grossing up NZ\$1million of annual PAYE by the highest marginal tax rate on individual income of 33%. Statistics on industry benchmarks from 2013/2014 financial data provided by Statistics New Zealand indicate that the salary and wages/turnover ratio for large enterprises located in the fourth quantile (turnover greater than NZ\$10 million) is between 6% and 22%.<sup>108</sup> Based on even the smallest turnover ratio of 6% it is clear that for an enterprise with an annual turnover exceeding NZ\$80 million (a large

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<sup>104</sup> ITA 2007, s CX 26.

<sup>105</sup> ITA 2007, ss RD 58 and RD 59(4).

<sup>106</sup> ITA 2007, s RD 59.

<sup>107</sup> ITA 2007, s RD 61(1)(a).

<sup>108</sup> Statistics New Zealand “Business Performance Benchmarks”  
<<https://www.stats.govt.nz/experimental/business-performance-benchmarker>> (last accessed 1 January 2019).

enterprise), the annual PAYE deduction will be more than the NZ\$1million threshold prescribed by s RD 61(1)(a) of the ITA 2007. Accordingly, this simple analysis shows that large enterprises are more likely to file quarterly FBT returns. Both the FBT return and FBT payment must be made by the 20th of the month that follows the end of the quarter.

#### *4.2.5 Cross-Border Taxation*

Due to the size of their activities large enterprises are likely to engage in cross-border operations which may involve transactions with overseas entities (import/export operations) as well as carrying out business activities overseas through a PE, such as branches, or through subsidiaries. From the perspective of a large enterprise which comprises of multinational enterprises operating in a variety of jurisdictions, tax compliance will extend beyond New Zealand. However, the focus of this section is specifically on the New Zealand taxation of the cross-border operations of either a multinational group of enterprises with a New Zealand resident parent or a multinational group of enterprises with an offshore parent, which has presence in New Zealand through a subsidiary or branch.

Large enterprises with a head office in New Zealand (New Zealand resident parent) are taxed on their worldwide income and therefore have to file an income tax return in New Zealand, which includes both New Zealand sourced and overseas income, which can be attributed to either the New Zealand head office or any other New Zealand resident member of a group.<sup>109</sup> Conversely, a large enterprise with head office located outside New Zealand, which operates in New Zealand through a subsidiary or branch, will be subject to income tax on New Zealand sourced income only.<sup>110</sup> Therefore, a large enterprise may only be partially affected by New Zealand cross-border tax regulations to the extent of the operations of its PE or subsidiary in New Zealand.

Taxation of the cross-border activities of a large enterprise in New Zealand is determined by the rules established in the ITA 2007 and by relevant DTAs. It should further be noted that cross-border taxation, and therefore the tax compliance of large enterprises, is increasingly

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<sup>109</sup> ITA 2007, s BD 1(4).

<sup>110</sup> ITA 2007, s BD 1(4).

affected by the newly adopted BEPS initiatives.<sup>111</sup> These initiatives have a purpose to strengthen the existing tax legislation and add new tax rules in order to combat the tax avoidance of offshore large enterprises generating business income in New Zealand. The BEPS initiatives will be discussed in more detail in the next subsection. This section will provide an overview of New Zealand tax regulation of cross-border activity. Specifically, the following tax rules will be outlined:

- Controlled Foreign Companies (CFCs);
- Thin Capitalisation; and
- Transfer Pricing.

#### *4.2.5.1 Controlled Foreign Companies*

The current CFCs rules were enacted in 2009 in order to protect the tax base in New Zealand and therefore prevent profit shifting to offshore jurisdictions. When a New Zealand large enterprise carries on business activities through subsidiaries established overseas, dividend income received from non-resident enterprise is exempt income for a New Zealand resident corporate shareholder under s CW 9 of the ITA 2007. Therefore the large enterprise in New Zealand does not have to pay tax on this dividend income. However, some types of overseas income earned by subsidiaries which meet the definition of a CFC, will be attributed to a large enterprise in New Zealand for which it will be liable to pay income tax. The CFC rules target New Zealand resident enterprises when they use offshore companies in order to shift profit-making activities of a passive nature, like dividends, interest, rent and royalties, out of New Zealand to jurisdictions with a lower tax rate.

What type of overseas enterprise will be considered to be a CFC? If fewer than five New Zealand resident shareholders own more than 50% of a foreign enterprise's decision-making rights, such as ownership of shares, the foreign enterprise will be considered a CFC<sup>112</sup> and therefore subject to the CFC rules. A large enterprise may include a CFC in a number of ways, depending on the complexity of a large enterprise's structure. For example, a large enterprise

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<sup>111</sup> See Adrian Sawyer and Richard McGill "The Adoption of BEPS in New Zealand" in Kerrie Sadiq, Adrian Sawyer and Bronwyn McCredie (eds) *Tax Design and Administration in a Post-BEPS Era: A Study of Key Reform Measures in 18 Jurisdictions* (Fiscal Publications, 2019) at 214, for further information on the recently adopted BEPS initiatives in New Zealand.

<sup>112</sup> ITA 2007, s EX (1).

which is a single New Zealand resident entity will include a CFC if the large enterprise owns more than 50% of the foreign company. A large enterprise which is comprised of a group of enterprises may also include a CFC if five or fewer of its members, each of whom is New Zealand resident, own more than 50% of the foreign company.

The key concepts regarding CFC income incorporate passive income and attributable income. Passive income can be understood as a type of income that involves no or minimal activity by a recipient in order to receive it. Passive income includes: <sup>113</sup>

- Interest;
- Dividends;
- Rent; and
- Royalties.

The idea of attributable income on a gross basis is described in s EX 20B of the ITA 2007. Under this section only certain types of passive income derived by a CFC are attributed back to New Zealand resident shareholders, including large enterprises. However, an attributable CFC income or loss, described in s EX 20B of the ITA 2007, is attributed to parent of the CFC on a net basis (taxable income minus tax deductible expenses) via the rules contained in ss EX 20C-EX 20E of the ITA 2007.

Apart from passive income, a CFC can derive active income from activities such as manufacturing and trading. Derivation of active income by a CFC is exempted from the attribution rules described above.<sup>114</sup> A CFC which derives both passive and active income will be exempt from attributing its passive income or losses to New Zealand resident shareholders, including a large enterprise, if the share of passive income in the total income of the CFC is less than five per cent.<sup>115</sup> A CFC with less than five per cent passive income is called “non-attributing active CFC”. Therefore, in order to determine whether a CFC’s passive income is less than five per cent it is necessary to undertake a test under which the ratio of passive income to total income of the CFC over the tax period (which usually runs from 1 April to 31 March) is calculated.

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<sup>113</sup>See IR “Resident Withholding Tax: Glossary” <<https://www.ird.govt.nz/rwt/info-help/rwt-glossary.html#res>> (last accessed 1 January 2019).

<sup>114</sup> ITA 2007, s EX 21B.

<sup>115</sup> ITA 2007, s EX 21B.

There are two ways that the test to calculate the passive income of a CFC and the total revenue derived by a CFC over a tax year, can be performed: use of the accounting method and use of the tax method. The accounting test can be applied on a single CFC basis or on the basis of a group of CFCs. The formula for the calculation of the passive income ratio in accordance with accounting standards is provided in s EX 21E(5) of the ITA 2007. This formula requires the calculation of passive income and total revenue according to accounting standards, whereby passive and total revenue amounts are calculated in the functional currency of the CFC,<sup>116</sup> which is the primary currency in which the CFC carries out its business activities.<sup>117</sup> The tax method can also be applied on a single CFC basis or on the basis of a group of CFCs, but requires that all CFCs in the group to which the test is applied to, be residents of the same country and liable for the income tax in that country.<sup>118</sup> For the tax method, all amounts must be converted to New Zealand dollars or a functional currency must be used.<sup>119</sup> A group of CFCs must be consolidated, and intercompany transactions and balances must be eliminated.<sup>120</sup> The formula for the calculation of the ratio under the tax method is provided in s EX 21D(4) of the ITA 2007.

As explained in subsection 4.2.1, all large enterprises defined for the purpose of this chapter have to comply with the requirements of the FRA 2013 and therefore prepare their financial statements based on NZ IFRS. NZ IFRS 10 requires a CFC to be included in the consolidated return of the New Zealand parent (a large enterprise).<sup>121</sup> Therefore, if a large enterprise chooses the accounting method for undertaking the test, a large enterprise can use information on the CFC passive income and total income from the set of accounts that the CFC or group of CFCs will prepare for the inclusion in the consolidated financial statement of the New Zealand parent (a large enterprise). Likewise, a large enterprise may opt for the tax method to undertake the test and use information from the tax returns that a CFC or a group of CFCs will file in the jurisdictions they are resident in. In any case, the requirement to determine whether a CFC or

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<sup>116</sup> ITA 2007, s EX 21E(4).

<sup>117</sup> NZ IAS 21: “The Effects of Changes in Foreign Exchange Rates”, para 8.

<sup>118</sup> ITA 2007, s EX 21D(1)(a).

<sup>119</sup> ITA 2007, s EX 21(4).

<sup>120</sup> ITA 2007, s EX 21(1B).

<sup>121</sup> NZ IFRS 10: “Consolidated Financial Statements”, para 2(a).



a group of CFCs is a non-attributing active CFC imposes additional obligations for a large enterprise which is the parent of CFC or a group of CFCs.

Section EX 22 of the ITA 2007 makes all Australian CFCs non-attributing CFCs and therefore there is no need for a New Zealand large enterprise to undertake the test described above for an Australian CFC. An Australian CFC is defined as an entity which is a tax resident of Australia and subject to tax in Australia. Therefore, having a CFC or a group of CFCs in Australia, should mean less compliance for a New Zealand large enterprise compared to in other jurisdictions, as there is no need to perform the test and to attribute passive income.

In summary, if a large enterprise in New Zealand has a CFC (or a group of CFCs), that large enterprise will have to attribute the passive income of its CFC (except for an Australian CFC). Accordingly, it must undertake a test using either the accounting or tax methods described above, in order to establish whether the CFC can be exempted from attribution. This is likely to lead to more tax compliance obligations.

#### *4.2.5.2 Thin Capitalisation*

The main purpose of the thin capitalisation regime is to prevent a non-resident enterprise (including a large enterprise) or a group of non-resident enterprises (including a group which meets threshold for a large enterprise as defined earlier in this chapter) from allocating an excessive portion of its worldwide debt to a New Zealand enterprise or a group of New Zealand enterprises. The thin capitalisation regime applies when a non-resident enterprise or a group of enterprises holds more than 50% of direct interest in a New Zealand enterprise or a group of New Zealand enterprises.<sup>122</sup> The thin capitalisation rules disallow a deduction for interest expenses for such a New Zealand enterprise, or a group of New Zealand enterprises, if the New Zealand enterprise's debt is greater than 110% of the non-resident enterprise or group of non-resident enterprises' worldwide debt, and the New Zealand group debt percentage is below 60%.<sup>123</sup> The interest deduction for the New Zealand enterprise or a group of New Zealand enterprises is disallowed if both of the thresholds noted above ("safe harbours") are breached.

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<sup>122</sup> ITA 2007, s FE (2)(c)(i).

<sup>123</sup> ITA 2007, s FE 5(1)(a)(i)(ii).

For example, as long as the New Zealand group debt percentage remains below 60% it does not matter whether the worldwide group percentage debt threshold is exceeded.

Therefore, in order to avoid the disallowance of interest expense, a non-resident large enterprise needs to comply with the thin capitalisation rules stipulated in s FE 5 of the ITA 2007 when it establishes a New Zealand subsidiary. This is applicable when it has more than 50% direct interest and finances its activity through worldwide debt.

As a non-resident large enterprise may own a number of enterprises in New Zealand, it becomes necessary to calculate a debt percentage of the whole New Zealand group, rather than just of a single enterprise. To this end, it is necessary to identify the New Zealand parent enterprise, which will determine what other enterprises should be included in the group. The parent enterprise will be a top-tier New Zealand enterprise that is an enterprise in which non-resident shareholders own more than 50% of direct ownership.<sup>124</sup> The New Zealand parent entity will make a determination about what other enterprises to include in the New Zealand group based on either the accounting test (greater than 50% ownership) or the tax test (greater than 66% ownership).<sup>125</sup> Once the New Zealand group has been formed, the next step will be to calculate the group debt percentage, which is achieved by consolidating the financial statements of every enterprise in the group under accounting principles (for example, NZ IFRS).

Total debt of the New Zealand group is defined in s FE 15 of the ITA 2007 and includes financial arrangements and financial leases.<sup>126</sup> There is no restriction on the source of debts. Any debt, whether borrowed from an associate (non-resident large enterprise) or in New Zealand from an arm's length lender (bank or other financial institution), is considered when calculating the New Zealand group debt. Section FE 15 of the ITA 2007 specifies that the financial arrangement must provide funds to the borrower and therefore, the New Zealand group must receive funds from its lender to be counted as debt under thin capitalisation rules.<sup>127</sup> Thus, swaps of interests or currency obligations, as well as other financial derivatives such as future contracts and options, will not be included in the definition of debt, as they do not provide funds directly to the New Zealand group.

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<sup>124</sup> ITA 2007, s FE 26.

<sup>125</sup> ITA 2007, s FE 27(2).

<sup>126</sup> ITA 2007, s FE 14.

<sup>127</sup> Coleman and others, above n 22, at 805.

In the case that a New Zealand group uses borrowed funds in order to lend it to a third party outside the New Zealand group, there is a concession stipulated in s FE 13 of the ITA 2007 which exempts a New Zealand group in this situation from the thin capitalisation rules. This concession is known as the on-lending concession and has been designed so that financial institutions and their subsidiaries in New Zealand will not be penalised by the regime.

Since the New Zealand group debt percentage is calculated by dividing the total amount of debt by the amount of the group's total assets, a group's total assets must be valued as well. Total assets can be valued in the following ways:<sup>128</sup>

- Values taken from the group's consolidated financial statements;
- Net current value of the assets; or
- Market selling value of the trading stocks (if the same valuation basis is used for tax purposes).

From 1 July 2018,<sup>129</sup> new BEPS initiatives require a New Zealand group to measure its total assets net of non-debt liabilities, which are defined in s FE 16B of the ITA 2007. Non-debt liabilities are all of the liabilities in the group's financial statements that are not counted as debt under s FE 15 of the ITA 2007. However, s FE 16B(1) excludes the following kinds of liabilities from the definition of non-debt liabilities:

- Certain interest free loans from shareholders;
- Certain shares held by shareholders (for example, preference shares);
- Provisions for dividends; and
- Deferred tax liabilities.

In addition, effective from 2014, the value of total assets used in the calculation of the debt percentage cannot include an asset uplift that has resulted from an internal revaluation.<sup>130</sup> Normally NZ IFRS requires many types of assets, including intangible assets, to be valued at cost. However, when enterprises in a New Zealand group become consolidated in what is called a "business combination", NZ IFRS 3 requires use of the fair market values of assets in the

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<sup>128</sup> ITA 2007, s FE 16(1).

<sup>129</sup> Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018, s 31.

<sup>130</sup> ITA 2007, s FE 16(1D).

financial statements of the consolidated enterprises,<sup>131</sup> and thus the value of assets can be inflated if they were revalued upward.

Total debt and total assets must be calculated in New Zealand dollars. Conversions from foreign currency must be made at the spot exchange rate on the relevant measurement day.<sup>132</sup>

The debt percentage of a non-resident large enterprise can be obtained from its consolidated financial statements which under s FE 17(a) of the ITA 2007, can be prepared based on the financial standards used in the jurisdiction that the non-resident large enterprise resides, or an ultimate parent resides if a non-resident large enterprise comprises a group of enterprises.

The debt percentage of the New Zealand group and worldwide debt percentage should be compared with the following thresholds<sup>133</sup> in order to check if the New Zealand group will be denied an interest expense on the borrowed funds:<sup>134</sup>

- 60 % safe harbour of New Zealand group's debt; and
- 110 % of the worldwide non-resident large enterprise's debt.

As mentioned in subsection 4.2.5.2, it is necessary to exceed both thresholds, before the thin capitalisation rules start to apply. The thin capitalisation regime may impose more tax obligations on non-resident large enterprises as they constantly need to monitor the debt percentage of their New Zealand enterprises or group of enterprises. This requires them to take into account all of the recently adopted rules (exclusion of non-debt liabilities and disallowance of the use of assets uplift) regarding the valuation of the New Zealand group's assets and to make sure that their debt to assets ratio stays below the designated thresholds.

#### *4.2.5.3 Transfer Pricing*

The transfer pricing regime is contained in ss GC 6-GC 14 of the ITA 2007. Its purpose is to prevent the erosion of the New Zealand tax base. Large enterprises operating in New Zealand through either a parent office or a subsidiary become subject to the transfer pricing regime

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<sup>131</sup> NZ IFRS 3: "Business Combinations", para 18.

<sup>132</sup> ITA 2007, s FE 10(3).

<sup>133</sup> ITA 2007, s FE 6(3)(e).

<sup>134</sup> ITA 2007, s FE 5.

when they engage in business transactions with associated persons.<sup>135</sup> This situation is typical for large enterprises when they have transactions with their subsidiaries (associated persons) located either in New Zealand or offshore. It should be noted that the transfer pricing regime rules apply to transactions between separate enterprises only (such as a parent enterprise and a subsidiary) and not to a transaction within a single enterprise (such as between a head office and a branch).

As large enterprises are often formed as a group comprising a number of separate enterprises, transfer pricing will apply in the following situations:<sup>136</sup>

- There is a supply and acquisition of goods and services (for example management services), financial loans, intangible properties (like trademarks, licenses);
- The supplier and acquirer are associated persons (within definitions of subpart YB of the ITA 2007); or
- The supplier is a resident enterprise in New Zealand and the acquirer is a non-resident enterprise located offshore, and vice versa.

When there is a transaction between a supplier and acquirer who are associated persons they often may adopt a price that does not reflect the market value of the transaction. This non-market price is charged so that the world-wide after-tax profits of a large enterprise will be maximised. In the event that the price charged by an associated person is not an arm's length amount, the transfer pricing regime will adjust this non-arm's length price and accordingly adjust the taxable income of the New Zealand resident enterprise (either the supplier or acquirer). The adjustment is undertaken by way of comparison of the price charged between the associated parties with the prices charged in similar but arm's length transactions between non-associated parties.

Therefore, a large enterprise which engages in cross-border transactions with associated persons, must use one of the five methods listed in s GC 13 of the ITA 2007 in order to determine the market (arm's length) amount of consideration and explain its calculation of the arm's length price to the IR.<sup>137</sup> Then it must compare the determined market amount with

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<sup>135</sup> Defined in subpart YB of the ITA 2007.

<sup>136</sup> ITA 2007, s GC 6.

<sup>137</sup> Coleman and others, above n 22, at 809.

the consideration charged for the transaction with the associated person. The five methods provided in s GC 13 of the ITA 2007 are:

- Comparable uncontrolled price (CUP);
- Resale price method (RPM);
- Cost plus (CP);
- Transactional net margin (TNM); and
- Transactional profit split (TPS)

Effective from 1 July 2018, the transfer pricing rules in New Zealand have been amended to incorporate the new BEPS initiatives. Consequently, attention will be paid to the economic substance of transaction rather than legal form of documentation. From 1 July 2018 the IR is empowered to reconstruct commercially irrational transfer pricing arrangements “which involve terms that the third parties would not be willing to agree to”.<sup>138</sup> In addition, the burden of proof that the transfer pricing is reasonable and reflects an arm’s length transaction price has been shifted onto the taxpayer (the large enterprise). Therefore, it is an obligation of a large enterprise to prepare documentation supporting the charged price.<sup>139</sup> Finally, the time period during which the IR can investigate and amend the tax return of a large enterprise has been extended from four years to seven years in relation to transfer pricing.<sup>140</sup>

One of the problems in complying with the transfer pricing regime which large enterprises face in New Zealand is the difficulty in finding comparable transactions for determining an arm’s length price. This difficulty arises because of the small size of the New Zealand economy which makes application of the first three methods listed above (CUP, RPM and CP) extremely difficult and therefore the last two methods (TPS and TNM) have to be used instead.<sup>141</sup> CUP, RPM and CP are considered to be the most reliable as they provide a comparison with similar transactions between independent parties. However, there are many factors to consider for a large enterprise in order to determine whether transactions between associated persons and transactions between independent parties are comparable (for example, factors such as the

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<sup>138</sup> Sawyer and McGill, above n 111, at 221.

<sup>139</sup> TAA 1994, s 149A(2)(b).

<sup>140</sup> ITA 2007, s GC 13(6).

<sup>141</sup> Coleman and others, above n 22, at 814.

characteristics of goods and services, industry type, contractual terms, business strategies and losses).<sup>142</sup>

#### *4.3 Further Aspects of Tax Obligations of Large Multinational Enterprises in New Zealand*

##### *4.3.1 Large Multinational Enterprises and BEPS Initiatives in New Zealand*

Among large enterprises (as defined earlier in section 4.1 of this chapter) which operate in New Zealand there is a sub-group of large enterprises which are multinational enterprises. IR have reported that there are 600 taxpayer groups in the significant enterprise segment with a turnover exceeding NZ\$80 million.<sup>143</sup> Of this number, 50% were foreign owned and another 25% were engaged in cross-border transactions mainly through CFCs.<sup>144</sup> Significant enterprises, as defined in section 4.1 above, receive closer attention from the IR because of their importance to tax revenue. Due to the size of their business operations, large multinational enterprises are included in the category of significant enterprises and, therefore, receive close attention from the IR.

The heightened interest from the IR to significant enterprises and especially multinational large enterprises is part of the IR's strategy to combat BEPS. In simple terms, BEPS is an arrangement that shifts profit to countries with lower taxes or makes income disappear, which potentially leads to double non-taxation of income. Large multinational enterprises are known for their ability to structure their business activities in ways which allow them to pay as little tax as possible anywhere in the world.<sup>145</sup> The wide range of tax planning techniques which large multinational enterprises exploit for achieving tax reduction purposes are known as BEPS tax strategies.

In 2012 the aggressive tax planning strategies of large multinationals became a focus of global media concern. Subsequently, in 2013 the G20/OECD adopted a 15-point Action Plan which recommended changing domestic tax rules, tax treaties and administrative measures in order

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<sup>142</sup> At 814-816.

<sup>143</sup> IR, above n 3.

<sup>144</sup> IR, above n 3.

<sup>145</sup> IR "Base erosion and profit shifting (BEPS) – update on the New Zealand work programme" (May 2016) <<http://taxpolicy.ird.govt.nz/publications/2016-other-cabinet-paper-beps-update/beps-update>> (last accessed 1 January 2019).

to allow countries to effectively and consistently combat BEPS.<sup>146</sup> In response to the G20/OECD's BEPS Action Plan, the New Zealand government released its own BEPS programme in 2016 to combat BEPS issues in New Zealand. The New Zealand legislative BEPS initiatives are contained in the Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018, which took effect from 1 July 2018. The newly adopted BEPS initiatives include the following:<sup>147</sup>

- Interest limitation rules (rules to prevent multinationals from charging artificially high interest rates on loans from related parties).<sup>148</sup> These rules require the debt interest rate to be determined in accordance with transfer pricing methodology.<sup>149</sup>
- New rules on related party transactions (transfer-pricing), which charge a price that does not have economic or commercial foundation.<sup>150</sup>
- New rules on PEs, which prevent large multinational groups from avoiding having a taxable establishment in New Zealand.
- Rules on combatting hybrid mismatch arrangements, which exploit differences in tax treatment of hybrid arrangements between different jurisdictions.<sup>151</sup>
- Empowering the IR to request further information from large multinational groups (information can be requested from offshore members of the group). These rules target large multinational groups with an annual turnover over EURO750 million (NZ\$1.3 billion).<sup>152</sup>

Discussion on further BEPs initiatives in New Zealand currently concerns issues of the digital economy and new business arrangements when large multinational enterprises provide digital

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<sup>146</sup> IR "Taxation (Neutralising Base Erosion and Profit Shifting) Bill-Commentary on the Bill" (2017), at 3.

<sup>147</sup> Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018.

<sup>148</sup> Some of these rules have been discussed in the subsection 4.2.5.2 above on thin capitalisation.

<sup>149</sup> James Coleman and others *New Zealand Taxation 2019: Principles, Cases and Questions* (Thomson Reuters, Wellington, 2018), at 818.

<sup>150</sup> Some of these rules have been outlined in the subsection 4.2.5.3 above on transfer pricing.

<sup>151</sup> Examples of situations that can be impacted by these rules include: loans that are treated as debt in one country and equity in another; deduction of interest on accrual basis while recognising interest income on cash basis; dual resident enterprises.

<sup>152</sup> EURO-NZ\$ exchange rate (1 NZ\$ = 0.58 EURO). See IRD "Currency rates – rolling average" <<https://www.ird.govt.nz/resources/8/d/8de01e54-60d4-49ad-9e89-dd185007c345/mid-month-nov-2018.pdf>> (last accessed 29 December 2018).



services in New Zealand while not having taxable presence that falls under the definition of PE.<sup>153</sup>

#### *4.3.2 Large Multinationals' Tax Compliance*

As a part of the BEPS strategy the IR requires large multinational enterprises to submit yearly, a basic compliance package (BCP), which includes information on group structure, financial statements and tax reconciliation. Based on the risk level which is gauged by reviewing the BCP, the IR determines if further compliance interventions are necessary. In 2015, the IR introduced an International Questionnaire,<sup>154</sup> which large multinational enterprises must complete, providing information on such aspects as:

- Name and IR number of the New Zealand parent.
- Country and name of the ultimate parent enterprise.
- New Zealand group financial statements data (gross revenue, gross profit, selling, general and administration expenditures, total assets (excluding goodwill), and total liabilities). This data must be taken from the consolidated financial statements of the New Zealand group which are filed with the Companies Office.<sup>155</sup>
- Amount of tax adjustments (if any) in relation to interest income/expense. This adjustment may be necessary because of a disallowance of interest expense due to thin capitalisation.
- Issues with transfer pricing. If there was greater than NZ\$10 million of interest-bearing debt with a non-resident associated person and what was the highest interest paid by a member of the New Zealand group during the year.
- Amount of financing that any member of the New Zealand group held during the year and which was issued by a non-resident associated person. Financial instruments with a face value of NZ\$30 million raise red flag if a deduction of interest expense from this financial instrument in New Zealand is not accompanied by the corresponding interest income taxable in other jurisdictions.

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<sup>153</sup> New Zealand Government Tax Working Group “International Issues in Taxing Business Income” (September, 2018).

<sup>154</sup> IR, above n 3, at 4.

<sup>155</sup> IR “International Questionnaire 2017 – Guidance notes”.

- Country-by country report (CbCR). This report must be prepared by large multinational groups with annual turnover over EURO750 (NZ\$1.3 billion)<sup>156</sup> where the ultimate parent is located in New Zealand.

In order to strengthen tax compliance among large multinational enterprises, the IR in accordance with the tax control framework<sup>157</sup> released by the OECD's Forum on Tax Administration,<sup>158</sup> expects large multinational enterprises to establish good and effective tax governance. It is expected that there will be a documented tax strategy, and effective systems and procedures will be put in place to manage tax risk. Moreover, the annual financial statements prepared by a large multinational enterprise should contain a reconciliation of the income tax expense in the financial statements with the actual amount of cash remitted to the IR.<sup>159</sup> Very close attention is paid to the effective tax rate of large multinational groups, especially if the effective tax rate is substantially lower than New Zealand statutory rate of 28%.

As discussed earlier in section 4.2.5.1, large enterprises in New Zealand may have attributed income from a CFC if the CFC fails to pass the active business income test and there is net passive income. The IR specifically focuses on how the active business income test is performed and the calculation of taxable income or losses, which must be attributed from a CFC. In particular, a large multinational enterprises must provide the following information in regard to their CFCs and ensure that appropriate procedures are taken. First, large multinational enterprise must disclose annually its interest in CFCs using form IR458 (Foreign investment fund/Controlled foreign company disclosure(s)). Second, if a large multinational enterprise uses the accounting method for undertaking the active business income test, financial statements must be prepared in accordance with IFRS or NZ IFRS and have an unqualified audit opinion.<sup>160</sup> Third, a CFC's passive income has a number of exemptions from attribution (for example, rental income derived from land situated in the same jurisdiction where the CFC

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<sup>156</sup> EURO-NZ\$ exchange rate (1 NZ\$ = 0.58 EURO). See IRD "Currency rates – rolling average" <<https://www.ird.govt.nz/resources/8/d/8de01e54-60d4-49ad-9e89-dd185007c345/mid-month-nov-2018.pdf>> (last accessed 29 December 2018).

<sup>157</sup> The tax control framework is the set of processes and internal control procedures, which ensure that an enterprise's tax risks are known and controlled, and tax obligations are met in a timely manner.

<sup>158</sup> OECD "Co-operative Tax Compliance - Building Better Tax control Framework" (Paris, 2016).

<sup>159</sup> IR above n 3, at 1 and 4.

<sup>160</sup> At 10.

is located) and therefore a large multinational enterprise needs to undertake a review to see if any of these exemptions apply to it.<sup>161</sup>

#### *4.3.3 Large Multinational Groups and Their Tax Obligations in New Zealand*

Thus far, the discussion in this chapter has mainly covered the tax compliance of large multinational enterprises operating in New Zealand. However, there is a special segment within the category of large multinational enterprises which deserves separate consideration in this section. This special segment is that of large multinational groups<sup>162</sup> and includes a group of enterprises with a member resident in New Zealand and other members being resident of a country other than New Zealand. The turnover of such group must exceed EURO750 million (NZ\$1.3 billion)<sup>163</sup> in a year.

The recently enacted Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018 allows the Commissioner of Inland Revenue (CIR) to request any additional information or documentation from any member of a large multinational group including non-resident members.<sup>164</sup> For instance, the CIR can request that a New Zealand subsidiary of a large multinational group provide additional documentation on transfer pricing. If the New Zealand subsidiary does not have the requested documentation, it must source the documentation from other members of the group and submit it to the IR.<sup>165</sup> Where a large multinational group fails to provide the requested documentation, s 139AB of the TAA 1994 allows the CIR to impose a civil penalty of NZ\$100,000.

Although the Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018 has provided the IR with new powers to investigate large multinational groups, New Zealand members within large multinational groups will be treated only as agents for tax liabilities of the non-resident group members. Moreover, if a New Zealand member of such a large multinational

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<sup>161</sup> At 10.

<sup>162</sup> See section 4.1 of this chapter for the definition.

<sup>163</sup> EURO-NZ\$ exchange rate (1 NZ\$ = 0.58 EURO). See IRD “Currency rates – rolling average” <<https://www.ird.govt.nz/resources/8/d/8de01e54-60d4-49ad-9e89-dd185007c345/mid-month-nov-2018.pdf>> (last accessed 29 December 2018).

<sup>164</sup> Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018, s 56 and 57; TAA 1994, s 17(1CB).

<sup>165</sup> IR “Definition of Large Multinational Group” (August 2018), at 3; TAA 1994, s 17(1CB).

group has been assessed as an agent, the New Zealand member will be able to dispute this assessment.<sup>166</sup>

In the tax years commencing after 1 January 2016, large multinational groups where the ultimate parents are headquartered in New Zealand are required to file a CbCR within 12 months after the reporting year end.<sup>167</sup> The report contains information on the group's operations in each jurisdiction where the group operates. Specifically, a CbCR should contain the following information:<sup>168</sup>

- Gross revenue;
- Profit or loss before income tax;
- Amount of income tax paid on a cash basis;
- Amount of accrued income tax expense in the current year;
- Stated capital;
- Retained earnings;
- Number of employees; and
- Value of tangible assets.

In addition, a large multinational group needs to provide a list of all its enterprises in each of the jurisdictions it operates and describe the business activity of each enterprise.<sup>169</sup> The form IR1032 is prescribed for completing a CbCR.<sup>170</sup> The information which must be included in the report can be taken from the consolidated financial statements which an ultimate New Zealand parent of a large multinational group must prepare in accordance with the requirements of the FRA 2013. Currently, the requirement to file a CbCR applies to about 20 multinational groups in New Zealand who have been notified by the IR.<sup>171</sup>

In addition, recently adopted BEPS initiatives in New Zealand strengthen the PE rules for large multinational groups. A large multinational group may structure the sale of their goods and

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<sup>166</sup> Sawyer and McGill, above n 111, at 225.

<sup>167</sup> TAA 1994, s 78G.

<sup>168</sup> IR *IR1032: Country-by-Country Report* (May 2018).

<sup>169</sup> IR, above n 165, at 9.

<sup>170</sup> IR, above n 165.

<sup>171</sup> IR, above n 165, at 9.

services in New Zealand in a way that allows avoiding a PE in New Zealand and therefore avoiding having a source of taxable income. Often a large multinational group sells goods and services in New Zealand from one of its members (non-resident member) located in a low tax jurisdiction, through their subsidiary in New Zealand. Subsidiaries locate customers and promote the products of the non-resident member to them, while the non-resident member gives approval and signs contracts. Under the current PE rules set out in DTAs, subsidiaries of large multinational groups do not become a “dependent agent” in this situation as they do not have full autonomy in the decision-making regarding the selling of the goods and services. Therefore, a large multinational group will arguably not have a PE in New Zealand despite the fact that both the large multinational group and its subsidiary in New Zealand are operating as one economic entity. The recently passed Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018 introduced new PE anti-avoidance rules which will deem a PE to exist in New Zealand for a non-resident member of a large multinational group if the following conditions are met:<sup>172</sup>

- The non-resident member is a part of a large multinational group;
- The non-resident member makes a supply of goods and services to a person in New Zealand;
- A person carries on activity in New Zealand in order to facilitate the supply of these goods and services;
- A person is either associated with the non-resident member or depends commercially on it; and
- The purpose of the arrangement is to avoid having a PE in New Zealand.

It is possible that the compliance of a large multinational group will increase as a result of the adoption of the new PE rules as large multinational groups will have to examine the risks of having a PE in New Zealand under the current arrangements and re-structure in response to these risks. In addition, if a large multinational group is deemed to have a PE under the new rules, it will have to apportion sales income between the PE in New Zealand and the offshore operations of its non-resident member based on the amount of contribution each makes to the sales income in New Zealand.

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<sup>172</sup> IR, above n 146, at 40.

#### *4.4 Conclusion*

This chapter has provided an overview of the tax compliance obligations for large enterprises in New Zealand. A large enterprise has been defined as either a single entity or a group of entities operating in New Zealand with an annual turnover being above NZ\$80 million threshold. The tax compliance obligations of large enterprises operating in New Zealand predominantly include compliance with taxes such as business income tax, GST, PAYE and FBT. Each of these taxes along with their major compliance procedures have been discussed in this chapter.

Cross-border transactions are most likely to add greater compliance obligations for large enterprises given that there are complex rules to follow when a large enterprise engages in cross-border operations through a CFC or has transactions with associated overseas enterprises. In the case of CFCs, it is necessary to undertake an active business income test in order to determine whether a CFC's passive income must be attributed to a large enterprise in New Zealand and disclose its interest in the CFC. A large enterprise needs to determine a transaction price according to one of five methods provided in s GC 13 of the ITA 2007 in order to establish the transaction price that would be used between two independent parties in a similar situation.

Another situation that may add to the compliance obligations of a large enterprise in New Zealand is when a New Zealand subsidiary of a large enterprise is financed through debt. The thin capitalisation rules may deny the partial deductibility of interest expenses for a New Zealand subsidiary if the thresholds ("safe harbour") established by the thin capitalisation rules are exceeded. To avoid this situation a large enterprise needs to monitor the level of debts and assets of the New Zealand and world-wide group and ensure that thresholds levels are not breached.

Large multinational enterprises are likely to face further compliance obligations due to the recently enacted BEPS Action Plan and the requirements to provide additional documentation, such as the BCP requested by the IR. In addition, they are expected by the IR to establish good tax governance in order to have effective tax systems to manage tax risks. Large multinational groups represent a special segment of large enterprises, comprising only 20 such groups headquartered in New Zealand. They face even higher compliance obligations and may be requested by the CIR to provide any additional information regarding their business activities. These large multinational groups are required to file a CbCR providing information on the

business activities of each of their enterprises in each jurisdiction where these enterprises operate.

Next chapter will present an outline of research methodology applied in this study to address research questions. The outline will include description of the methodological approach as well as elaboration of the method used to collect data.

## Chapter 5: Conceptual Framework and Methodology

### *5.1 Introduction*

This chapter presents the conceptual framework of the costs of tax compliance and the methodological approach applied in this study to answer the research questions set out in Chapter 1. A conceptual framework is presented here in order to introduce the types of tax compliance costs, how they can be measured and what the difference between the internal and external costs of tax compliance is. The discussion on the conceptual framework is extended in order to introduce the idea of the unobservable costs of tax compliance, which have not been considered in prior studies that were presented in Chapter 2. A model of cost efficient tax compliance administration, based on the premises of the Rational Choice Theory, is also introduced in this chapter in order to demonstrate how cost efficient tax compliance administration can assist in reducing the unobservable costs of tax compliance. Although, it is not a purpose of this study to measure the costs of tax compliance and efficiency of tax compliance administration of large enterprises, a conceptual framework and the model serve as a guide in considering what are the relevant tax compliance costs for large enterprises.

The methodological approach will explain the method this study applies in order to collect and process the findings to address the research questions. The structure of this chapter is as follows. Section 5.2 introduces the conceptual framework, followed by section 5.3, which explains the idea of unobservable costs of tax compliance and sets out the model of optimal tax compliance administration. Section 5.4 discusses the methodology of this study and section 5.5 then summarises the chapter.

### *5.2 Conceptual Framework for Measuring Tax Compliance Costs*

The majority of empirical studies investigating the issue of tax compliance costs presented in Chapter 2 draw upon the conceptual framework on the measurement of tax compliance costs proposed by Sandford, Godwin and Hardwick.<sup>1</sup> This conceptual framework is briefly outlined

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<sup>1</sup> Cedric Sandford, Michael Godwin, and Peter Hardwick *Administrative and Compliance Costs of Taxation* (Fiscal Publications, Bath, 1989).



below. As already mentioned in Chapter 1, there is a distinction between gross and net tax compliance costs, where the former represents *social* tax compliance costs and the latter the costs directly born by taxpayers.

*Gross tax compliance costs:* These costs consist of monetary and psychological costs. Monetary costs represent the value of resources that a firm expends on compliance with tax regulations. The gross monetary value of tax compliance costs consists of two components:

- Labour costs
- Non-labour costs

Labour costs include the costs of internal labour; for example, employees or contractors, and also external labour costs, which refer to outlays on services provided by external tax practitioners.<sup>2</sup> In the case of large enterprises the types of tax compliance activities undertaken in-house and the services provided by external tax practitioners may range from record keeping, preparation and lodgement of tax returns to advice in relation to information technology systems relating to tax matters.<sup>3</sup> Internal labour costs can be measured by multiplying the time spent by internal staff on particular tax activities by their average hourly wage rate. External labour costs can be obtained from records on amounts that a business expends on services from external tax practitioners, accountants and lawyers. Usually external labour costs can be obtained only as a lump-sum amount.<sup>4</sup>

Non-labour costs usually constitute costs incidental to tax compliance activities, such as purchasing of the specialised tax accounting software or internet bills. Non-labour costs can be either of recurring (internet bills) or capital nature (laptop or specialised tax accounting software). As Evans and Tran-Nam<sup>5</sup> indicate, it is normal to exclude both recurring costs and capital costs from the calculation of tax compliance costs due to the fact that recurring costs are related to labour costs and capital investments can be used for purposes other than tax

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<sup>2</sup> Chris Evans and Binh Tran-Nam “Tax Compliance Costs in New Zealand: An International Comparative Evaluation” (Tax Administration for the 21st Century Working Paper, Victoria University of Wellington, 2014) at 9.

<sup>3</sup> Chris Evans, Philip Lignier and Binh Tran-Nam “Tax Compliance Costs of Large corporations: An Empirical Inquiry and Comparative Analysis” (2016) 64 Canadian Tax Journal 751 at 779, 780.

<sup>4</sup> Evans and Tran-Nam, above n 2, at 9.

<sup>5</sup> At 10.

compliance activities. Inclusion of capital costs would require apportioning of the costs directly related to tax compliance, which is very difficult in practice.

Psychological costs related to tax compliance represent the negative emotional aspects of dealing with tax system.<sup>6</sup> They usually refer to stress, anxiety and frustration caused by tax obligations, and are very difficult to quantify. These costs are particularly relevant to small businesses, because they have limited resources and opportunities to rely on the services from professional tax advisers.<sup>7</sup>

*Net tax compliance costs:* Tax compliance can bring not only a burden to a taxpayer, but also a number of benefits. These benefits can partially offset *gross* tax compliance costs resulting in *net* tax compliance costs. The literature identifies the following types of benefits to taxpayers ensuing from tax compliance activities:

- Cash flow benefits: This type of benefit is particularly relevant in the case of firms and arises when there is a gap in the time between when a tax payment is due and when it is actually paid to the government. This benefit is particularly noticeable when an employer withholds income tax (pay as you earn (PAYE)) from salary payments to employees on their behalf, but does not immediately remit the withheld tax amounts. Payments of Value Added Tax (VAT) or Goods and Services Tax (GST) is another example of cash flow benefits that might accrue to a business taxpayer.<sup>8</sup>
- Deductibility benefits: Expenses incurred by businesses on tax compliance are generally deductible in the calculation of the business income tax.

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<sup>6</sup> Robin Woellner and others “Taxation or Vexation-Measuring the Psychological Costs of Tax Compliance” in Chris Evans, Jeff Pope and John Hasseldine (eds) *Tax Compliance Costs: A Festschrift for Cedric Sandford* (Prospect, Sydney, 2001).

<sup>7</sup> Evans and Tran-Nam, above n 2, at 8.

<sup>8</sup> It worthwhile to note here, that the New Zealand context, it is small enterprises rather than large enterprises who are more likely to enjoy the cash flow benefits from withheld payroll taxes (PAYE) and GST received. In the case of PAYE, a small enterprise or “small employer” (with an amount of withheld payroll taxes within a 12 month period of less than NZ\$500,000) has at least 20 days to remit to the Inland Revenue (IRD) the withheld amount of payroll taxes (Income Tax Act 2007, s RD 4(1) and s RD 22(3)). In the case of GST payments, the Goods and Services Tax Act 1985 allows business entities, whose total taxable supply in the last 12 months have not exceeded or not likely to exceed in the next 12 months NZ\$500,000, to remit GST received once every six months.

- Managerial benefits: This type of benefit ensues from the fact that tax compliance promotes better record-keeping of business financial transactions which can lead to an improvement in the information available for management decision making.

The above discussion regarding the conceptual issues of tax compliance costs and their measurement can be summarised through the following equations:

$$1. \text{ Gross Tax Compliance Costs} = \text{Internal Labour Costs} + \text{External Labour Costs} + \text{Non-Labour Costs (Capital and Recurrent Expenses)}$$

If non-labour costs are ignored in the above equation, then gross tax compliance costs can be measured as the sum of two variables: internal and external labour costs

$$2. \text{ Net Tax Compliance Costs} = \text{Gross Tax Compliance Costs} - \text{Tax Compliance Benefits (Cash, Deductibility and Managerial Benefits)}$$

While quantification of the first two benefits (cash and deductibility) appears to be feasible in practice, managerial benefits are very difficult to quantify. The majority of studies to date rarely used managerial benefits in their estimations.<sup>9</sup>

It is worthwhile to note that there are unresolved aspects related to the measurement of tax compliance costs. These aspects relate to the questions of whether to consider tax planning as a part of tax compliance and accordingly, whether the costs that arise in connection with tax planning should be included in total tax compliance costs. In this regard, tax planning is viewed as a form of “avoidable” tax compliance costs in contrast to “unavoidable” tax compliance costs; for example, computation of the income tax which is due to the revenue authority. The idea that tax planning should be counted as a legitimate tax compliance activity has been strongly debated by policy-makers who insist that only the costs relating to computation of tax must be considered as a part of tax compliance costs.<sup>10</sup> In contrast to this view, Evans and Tran-Nam suggest that tax planning should be considered as part of tax compliance activities and therefore the costs of tax planning should also be included in the estimation of tax compliance

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<sup>9</sup> Binh Tran-Nam and others “Tax Compliance Costs: Research Methodology and Empirical Evidence from Australia” (2000) 53(2) National Tax Journal 229 at 232.

<sup>10</sup> Chris Evans “Taxation Compliance and Administrative Costs: An Overview” in Michael Lang, Christine Obermair, Josef Schuch, Claus Staringer and Patrick Weiniger (eds) *Tax Compliance Costs for Companies in an Enlarged European Community* edited by (Kluwer Law International, The Netherlands, 2007) at 452.

costs.<sup>11</sup> However, tax planning activities and tax computational activities have not been separated in the majority of previous studies,<sup>12</sup> apparently because it is almost impossible to disentangle the costs of tax planning from the overall costs of tax compliance.<sup>13</sup> Along similar lines, according to Evans and Tran-Nam,<sup>14</sup> costs arising in connection with legal disputes of businesses with tax authorities regarding a particular tax position should also be included in the measurement of tax compliance costs.

Among the types of costs of tax compliance outlined above the estimation of the gross costs of tax compliance will be more relevant in the case of large enterprises. This is because managerial benefits and cash benefits, which are main components of the net tax compliance costs, are likely to have little effect for large enterprises in New Zealand. Given that large enterprises have accounting systems in place that they need to maintain for purposes other than taxation managerial benefits ensuing from tax compliance should be of much less tangible value for large enterprises. As for the cash benefits, which might ensue from withholding PAYE and retaining GST payable amounts, New Zealand's Inland Revenue (IR) requires large enterprises to remit withheld payroll taxes twice a month and GST payable once a month.<sup>15</sup> These two requirements largely negate cash benefit effect for large enterprises in New Zealand.

### *5.3 Unobservable Costs of Tax Compliance*

#### *5.3.1 What are the Unobservable Costs of Tax Compliance?*

The costs of tax compliance presented in section 5.2 above, except for psychological costs, can usually be both observed in practice and measured. Observable costs of tax compliance, such as internal staff labour costs and service fees of external tax practitioners, have been used in order to estimate gross tax compliance costs in the previous empirical studies introduced in Chapter 2 of this thesis. Therefore, in prior studies the estimation of the costs of tax compliance

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<sup>11</sup> Evans and Tran-Nam, above n 2, at 11.

<sup>12</sup> See Cedric Sandford *Hidden Costs of Taxation* (Institute for Fiscal Studies, London, 1973); Cedric Sandford, and others *Costs and Benefits of VAT* (Heinemann, London, 1981).

<sup>13</sup> Evans, above n 10, at 452.

<sup>14</sup> Evans and Tan-Nam, above n 2, at 11.

<sup>15</sup> Income Tax Act 2007, ss RD 4(1) and RD 22(3); Goods and Services Tax Act 1985, s 15(4).

has been based only on observable costs. However, gross tax compliance costs are determined not only by the expenses on internal staff and by outlays on external services provided by tax practitioners, but also by how the tax compliance activity is implemented by large enterprises. Large enterprises usually have a choice of various strategies, or tax compliance administration, for dealing with their tax compliance: tax compliance can be performed wholly or partly in-house or outsourced to external tax practitioners. For tax compliance which is carried out in-house a large enterprise might opt for investing in specialised automated systems, which would significantly facilitate the processing of a large number of transactions. Eichfelder and Schorn argue that adoption of cost efficient (cost minimising) tax compliance administration affects cost of tax compliance as cost efficient choice assists in minimising cost of tax compliance.<sup>16</sup> In other words, tax compliance administration is also considered to be a factor that either increases or decreases costs of tax compliance. According to Lignier, Evans and Tran-Nam<sup>17</sup> the costs of tax compliance which arise due to inefficient tax compliance administration are referred to as unobservable costs of tax compliance as these costs cannot be observed in practice.

The fact that costs which arise from inefficient tax compliance administration cannot be observed in practice does not mean that these costs cannot be estimated. Economic theory, especially neoclassical economics, has theories available to deal with the issues of cost efficiency.<sup>18</sup> One of the theories provided by neoclassical economics which explains how the cost efficient choice is made by economic agents is the Theory of Rational Choice. Before moving to a discussion of the Theory of Rational Choice, it is suffice to say that the Rational Choice Theory offers a basis for modelling the cost efficient behaviour of economic agents. If unobservable costs of tax compliance occur because a large enterprise chooses a tax compliance strategy which is not cost minimising (cost efficient) then by modelling the cost efficient tax compliance strategy, unobservable costs of tax compliance can be estimated.

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<sup>16</sup> Sebastian Eichfelder and Michael Schorn “Tax Compliance Costs: A Business Administration Perspective” (2012) 68 *FinanzArchiv: Public Finance Analysis* 191 at 192.

<sup>17</sup> Philip Lignier, Chris Evans and Binh Tran-Nam “Measuring Tax Compliance Costs: Evidence from Australia” in Chris Evans, Richard Krever and Peter Mellor (eds) *Tax Simplification* (Kluwer Law International, The Netherlands, 2015).

<sup>18</sup> Alexandr Soukup, Mansoor Maitah and Roman Svoboda “The Concept of Rationality in Neoclassical and Behavioural Economic Theory” (2014) 9 *Modern Applied Science* 1 at 2.

### 5.3.2 Rational Choice Theory

The Theory of Rational Choice is at the heart of neoclassical economics.<sup>19</sup> An informal definition of the rational choice states that “the choice is said to be rational when it is deliberative and consistent”.<sup>20</sup> According to this informal definition, the decision maker has thought about what they are going to do and their actions, which are based on choices they make, exhibit consistency. In other words, there should be no unexpected and inexplicable swings in their choices over time and that the means they choose are well-suited for attainment of their goals.<sup>21</sup> This definition lacks precision and does not seem to allow us to separate rational behaviour from irrational, as almost every action would seem to be “deliberative” and “consistent”.<sup>22</sup>

The formal definition of rational choice is better explained by referring to the example of consumers who have transitive preferences and who strive to maximise their utility subject to various constraints. Transitive preferences are those preferences for which the following statement is true: if a consumer prefers good A over good B and B is preferred to good C, then for that consumer good A is preferred over good C.<sup>23</sup> Similarly, economists assume that utility maximisation by a consumer is an obvious trait and they are puzzled if someone does not display it.<sup>24</sup>

Economists have found the Rational Choice Theory to be a very useful and strong tool for modelling firms’ behaviour. As an example, economic theory predicts that when wages increase, the demand for labour decreases while the supply of the labour increases. Similarly, when the price of a good or service rises, all other things being equal, production will shift toward the supply of that good or service. When the price of input increases relative to its

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<sup>19</sup> Thomas Ulen “Rational Choice Theory in Law & Economics” in Boudewijn Bouckaert and Gerrit De Geest (eds) *Encyclopedia of Law and Economics: Volume I - The History and Methodology of Law and Economics* (Edward Elgar, Cheltenham, 1999) at 791.

<sup>20</sup> At 791.

<sup>21</sup> At 791.

<sup>22</sup> At 792.

<sup>23</sup> At 793.

<sup>24</sup> At 793.

substitute, a rational producer will use more of the substitute and less of the input which has become more expensive.

Deviations from the results predicted by the Rational Choice Theory are largely attributed to market failures (such as monopoly or monopsony), asymmetry of information, public goods, which prevent a rational economic agent from making rational and optimal decisions.<sup>25</sup> Even if a consumer exhibits behaviour that is thought to be anomalous to the predictions of the theory, economists can still explain it by making a slight amendment to the theory.<sup>26</sup> For example, if consumers react to the increase in a price of a good by increasing their demand for it, an economist might describe such a seemingly irrational phenomenon, as a “snob” effect.<sup>27</sup>

There is a presumption among economists that rational consumers will prosper, while irrational consumers will waste their resources. Rational profit-maximising businesses will outperform those businesses that do not operate according to a rational plan.<sup>28</sup>

Nobel Prize winner Garry Becker has shown that even if there is a large number of consumers with intransitive preferences, and who behave irrationally due to this fact, their irrational behaviour does not affect the prediction of the Theory of Rational Choice much and it is not an issue for the aggregate market behaviour.<sup>29</sup> Thus, the presence of “irrational” consumers can be ignored.

The discussion below now moves to the simple model of rational choice which describes the relationship between tax compliance costs and the tax administration strategy pursued by a profit-maximising taxpayer.

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<sup>25</sup> At 794.

<sup>26</sup> At 794.

<sup>27</sup> At 794.

<sup>28</sup> At 794.

<sup>29</sup> Garry Becker “Investment in Human Capital: A Theoretical Analysis” (1962) 70 *Journal of Political Economy* 9.

### *5.3.3 Model of Tax Compliance Costs Strategy under the Assumption of the Rational Choice Theory*

In order to demonstrate how a rational decision-making taxpayer adopts the strategy that minimises their tax compliance costs, a mathematical model based on the premise of the Theory of Rational Choice has been taken from Eichfelder and Schorn.<sup>30</sup> In line with the Rational Choice Theory a rational decision taxpayer (a large enterprise) strives to maximise net income for which it has to take into account both taxes and tax compliance costs. For simplicity this model does not consider exceptions to the Theory of Rational Choice such as “bounded” rationality<sup>31</sup> or “limited information”.

The model can be briefly outlined as follows. A large enterprise employs both internal (in-house personnel and capital, for example, automated technology) and external (tax practitioners) resources in order to comply with its tax obligations. It is assumed in the model that the in-house personnel and capital resources have different efficiency parameters, which are less than 1. For simplicity, the efficiency parameter of the external tax practitioners is assumed to be equal to 1. Being rational (the main assumption in the framework of the Rational Choice Theory) a large enterprise strives to maximise its net income subject to a constraint. This constraint is represented in the model by the tax compliance activity which the large enterprise cannot avoid. At the same time, the large enterprise resorts to a tax planning activity in order to minimise taxes it has to pay. Maximisation of net income is achieved through minimisation of the costs expended on the tax compliance activity taking into account the fact that the cost minimisation is constrained by the amount of the tax compliance activity on which some portion of the costs must be expended.

Notwithstanding a number of simplifying assumptions made in the model, it can nevertheless predict the optimal behaviour of a rational business taxpayer in regard to their tax compliance costs strategy. The model predicts that the cost efficient condition (that is when the costs associated with the implementation of the tax compliance activity are minimised) is achieved

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<sup>30</sup> Eichfelder and Schorn, above n 16.

<sup>31</sup> The assumption that when economic agents make decisions their rationality is “bounded” by the amount of information available, meaning that they cannot be fully rational in their choice due to the limited information. In addition, not only does information appear to be limited, but also the time required to make decision is limited as well. Consequently, economic agents seek a “satisfactory” solution, rather than the optimal solution. The term “bounded rationality” was first coined by Herbert Simon in 1955. See Herbert Simon “A Behavioural Model of Rational Choice” (1955) 69 Quarterly Journal of Economics 99.



when the marginal cost of one unit of internal staff, adjusted for the productivity of internal staff, will be equal to the marginal cost of one unit of capital, adjusted for its productivity, and equal to a market price of the external tax practitioner.

In the context of large enterprises this model can help to visualise the following cost optimal tax compliance strategy: efficient separation of tax compliance functions between internal staff and external tax practitioners. According to the model efficient separation implies performance of simpler tasks by internal personnel, while outsourcing more complex tasks to external tax practitioners.

Since it is not the purpose of this study to test this model, mathematical workings of the model are provided in Appendix 1 of this thesis.

## *5.4 Methodology*

### *5.4.1 Methodological Approach*

This study undertakes an analysis of the costs of tax compliance of large enterprises in New Zealand. In addressing the research questions set out in the Chapter 1 of this thesis, this study has adopted a qualitative methodology, specifically explorative analysis (the features of which will be elaborated further in this chapter). Although most of the previous studies of the costs of tax compliance in large enterprises are predominately quantitative, the reason why a qualitative research method has been adopted in this study is that undertaking of quantitative study appears to be problematic. As indicated in the literature review in Chapter 2, most quantitative studies of the costs of tax compliance of large enterprises use large scale self-administered surveys as a means of data collection.

However, the response rate of such large scale surveys is usually low.<sup>32</sup> Among the studies presented in Chapter 2, only the Australian study showed a relatively high response rate of 42%. As explained in Chapter 2, subsection 2.4.2.2, such a high rate is attributed to the strong endorsement from Australian Taxation Authority (ATO) and professional bodies. Furthermore, as shown in Chapter 3, there is an issue with the definition of large enterprises in New Zealand.

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<sup>32</sup> European Commission “A Review and Evaluation of Methodologies to Calculate Tax Compliance Costs” (Taxation Papers Working Paper N.40, 2013).

This poses a significant challenge for conducting an empirical study. Considering this fact and also that to date no large scale survey has been undertaken among large enterprises in New Zealand for collecting information on the cost of tax compliance, it was decided to adopt qualitative methodology for this study.

Thus, rather than conducting a quantitative analysis that emphasises collection and econometrical analysis of data, this study focuses on words as the essence of qualitative analysis.<sup>33</sup> According to Cassell and Symon, qualitative research represents the process of collection and analysis of written or spoken texts and also directly observing the object(s) of study.<sup>34</sup> Qualitative analysis has been traditionally used in disciplines such as tax, accounting and law, where ethnographic research, grounded theory, case study and phenomenological research appear to be the most commonly applied approaches.<sup>35</sup>

Among the advantages of qualitative research are, first, the ability to provide detailed descriptions of the opinions and experiences of participants, based on which further interpretation can be made.<sup>36</sup> Secondly, qualitative data collection methods, such as unstructured and semi-structured interviews, allow direct interaction with participants during the data collection process.<sup>37</sup> Thirdly, qualitative research permits flexibility in designing the research structure,<sup>38</sup> which can be easily adjusted in response to the circumstances of the study. Finally, one form of qualitative research, exploratory analysis, can provide information which can be used as a baseline for future studies.<sup>39</sup>

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<sup>33</sup> Allan Bryman and Emma Bell *Business Research Methods* (3rd Edition, Oxford University Press, United Kingdom, 2007).

<sup>34</sup> Catherine Cassel and Gillian Symon *Qualitative Methods in Organizational Research* (Sage, London, 1994).

<sup>35</sup> Margaret McKerchar *Design and Conduct of Research in Tax, Law and Accounting* (Thomson Reuters, Pymont, 2010) at 94.

<sup>36</sup> Shidur Rahman “The Advantages and Disadvantages of Using Qualitative and Quantitative Approaches and Methods in Language “Testing and Assessment” Research: A Literature Review” 6 (2016) 102 at 104.

<sup>37</sup> At 104.

<sup>38</sup> Joseph Alex Maxwell *Qualitative research design: An interactive approach* (Sage, London, 2012).

<sup>39</sup> Joyce J Fitzpatrick and Meredith K Wallace *Encyclopedia of Nursing Research* (3rd ed, Springer, New York, 2012) at 169.

A disadvantage of qualitative research is that it does not allow the researcher to make generalisations of the findings over the larger population due to a small representative sample.<sup>40</sup> However, since the purpose of this study is to provide an exploratory analysis of the magnitude, composition and determinants of the costs of tax compliance of large enterprises in New Zealand, the generalisation of the results of this study over the wider population of large enterprises is not required.

Exploratory research or analysis, by definition, involves exploration and does not purport to provide a final and conclusive solution to the problem being investigated.<sup>41</sup> Therefore, research questions are principally explored during exploratory analysis without being given a confirmatory solution or conclusive evidence. Exploratory research represents an initial stage of studying a problem, laying down the groundwork for more conclusive analysis in the future. It assists in determining “research design, sampling methodology and data collection methods”.<sup>42</sup> Exploratory research is very useful in those situations when there is no, or very little, research on the problem or question which is being explored.<sup>43</sup> In this regard, exploratory analysis appears to be a useful methodological approach for this study as little research has been carried out to date on the tax compliance costs of large enterprises in New Zealand and the difficulties with collection of data pose a large challenge for conducting an empirical study.

The scope of exploratory analysis is rather broad as the definition of the word “exploration” includes “investigative exploration”, which purpose is to create something new, such as a method or design.<sup>44</sup> The definition also includes “innovative exploration”, which has a goal to achieve a “degree of familiarity with the properties and substances and procedures”.<sup>45</sup> Finally, “limited exploration” denotes types of exploration when a researcher knows what in particular they are looking for and systematically searches for it. In this type of exploration, discovery

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<sup>40</sup> Stanley Thomson “Qualitative research: Validity” (2011) 6 *Journal of Administration and Governance* 77 at 79.

<sup>41</sup> Mark Saunders, Philip Lewis and Adrian Thornhill *Research Methods for Business Students* (6th ed, Pearson Education, Harlow, 2012) at 140.

<sup>42</sup> Kultar Singh *Quantitative Social Research Methods* (Sage, New Delhi, 2007) at 64.

<sup>43</sup> Reva B Brown *Doing Your Dissertation in Business and Management: The Reality of Research and Writing* (Sage, London, 2006) at 43.

<sup>44</sup> Robert Stebbins *Exploratory research in the social science* (Sage, Thousand Oaks, 2001) at 3.

<sup>45</sup> At 3.

(“investigative exploration”) and innovation (“innovative exploration”) are of a secondary importance.

Since the purpose of this study is to investigate specific issues related to the costs of tax compliance of large enterprises in New Zealand, exploratory analysis in this study represents limited exploration. Moreover, both the conceptual framework for the measurement of tax compliance costs and the model of cost efficient tax administration, equip the researcher with a certain degree of clarity of the issues to explore in this study.

As Stebbins explains further, exploratory research (exploration) is primarily inductive, implying that the researcher uses the data obtained to induce an understanding of the underlying phenomenon in order to form a theory.<sup>46</sup> In contrast, confirmatory research (confirmation) uses a deductive approach, in which a model generated by an already existing theoretical framework is used to test a hypothesis. Therefore, the goal of exploratory research is to generate new ideas, make new discoveries or form new theories, particularly grounded theories, whereas the goal of confirmatory research is to verify the validity of existing models and test hypotheses. In this sense confirmatory research in “both the social and natural sciences is aimed at preventing discovery”.<sup>47</sup>

One important point to make in this regard is that although this study employs explorative analysis to address the research questions, it is not intended to be purely inductive. Rather, an explorative analysis of the costs of tax compliance of large enterprises in New Zealand relies on the findings of previous studies, as well as the conceptual framework and model (which were discussed in sections 5.2 and 5.3.3, respectively). Although no hypothesis is tested in this study, the findings of this study are compared with the existing empirical literature on the costs of tax compliance of large enterprises in order to confirm the validity of the findings. In this regard, the explorative analysis undertaken is a mixture of exploration and confirmation, as its findings are used to generate ideas about aspects of the cost of tax compliance in large enterprises in New Zealand. Furthermore, the findings can be verified (to see if they are in line with previous empirical studies).

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<sup>46</sup> At 3.

<sup>47</sup> Jerome Kirk and Marc Miller *Reliability and Validity in Qualitative Research* (Sage Publication, Newbury Park, 1986) at 15.

In line with exploratory analysis two main data collection methods can be used. One method is to conduct a case study or a number of case studies, while the other method is to employ interviews. A combination of these methods is also possible. For the reason explained in the next section interviews as the data collection method were chosen in this study. Interviews have been used to gain insight from the opinions of stakeholders who have knowledge about the costs of tax compliance in large enterprises and are experienced in practical aspects related to the taxation of large enterprises in New Zealand. For the reason, as elaborated further in this chapter, external tax practitioners from large chartered accountant firms and an IR official were chosen as the participants of the semi-structured interviews.

#### *5.4.2 Interviews*

##### *5.4.2.1 Why interviews and not a case study or a survey?*

A case study generally involves undertaking an in-depth exploration of a process, event or activity, during which a researcher seeks to understand a case in the context of its particular situation.<sup>48</sup> For example, in the case study of the cost of tax compliance of Hewlett-Packard (HP), a multinational company, the researcher, a tax counsel in HP, described a process of filing the United States (US) federal income tax return.<sup>49</sup> The purpose of the HP case study was to provide insight into details and the length of the tax filing process in order to demonstrate how long it takes a large multinational enterprise in the US to deal with the most complex part of tax compliance. In this regard, the advantage of carrying out a case study lies in the fact that in a result a detailed knowledge of a particular process (for example the process of complying with tax obligation) can be gained.

Often, a case study is undertaken in order to test some hypothesis or a theory and serves as a supplementary investigation in a quantitative research.<sup>50</sup> By the way of example, a case study of the cost of tax compliance of Indian corporations by Chattopadhyaya and Das-Gupta<sup>51</sup> was

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<sup>48</sup> McKerchar, above n 35, at 102.

<sup>49</sup> David R. Seltzer “Federal income tax compliance costs: a case-study of Hewlett-Packard company” (1997) National Tax Journal 50(3) 487.

<sup>50</sup> McKerchar, above n 35, at 103.

<sup>51</sup> Saumen Chattopadhyay and Arindan Das-Gupta “The Income Tax Compliance Costs of Indian Corporations” (National Institute of Public Finance and Policy, New Delhi, 2002).

carried out by the authors in order to elucidate certain important features of tax compliance activities which could not be ascertained through the questionnaire. In this respect, a case study may serve as a useful method for verification of quantitative findings already made.

The fact that this study does not seek to verify the validity of a hypothesis, nor to undertake in-depth analysis of how large enterprises in New Zealand comply with their tax obligations, makes the use of a case study as a method for collecting data to be less relevant.

Furthermore, Yin<sup>52</sup> argues that whether a case study is a right method depends on factors such as type of research questions posed. Thus, “how” and “why” research questions are more exploratory in nature and are likely to lead to the use of a case study method. The research questions such as “what”, “how much”, “who” and “where” are better addressed with survey method.<sup>53</sup> As noted, the research questions posed in Chapter 1 of this thesis are primarily “what” and “how much” type of questions. However, given the lack of certainty with the concept of large enterprises in New Zealand and exploratory nature of the current study, interviews appear to be a better way than a survey for obtaining a qualitative information.

The choice of the interview can also be explained by the following facts. First, as mentioned in chapter one, sub-section 1.1.3, self-administered large scale surveys usually have a low response rate. Second, in line with the qualitative methodology adopted, it is not the purpose of this study to generalise the findings over the wider population of large enterprises in New Zealand. Therefore, interviews were considered to be the most feasible method for collecting data for conducting explorative analysis. Furthermore, interviews provide the interviewer with an opportunity to uncover information which may not have been obtained through surveys.<sup>54</sup> During an interview the interviewer can ask additional questions in order to gain clarification or explore a problem more deeply, which is not possible to do in the case of a survey. Another advantage of conducting interviews over self-administered surveys is an ability to rephrase or simplify a question during an interview.<sup>55</sup> As a result, more accurate responses can be received, which increases the accuracy of data.

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<sup>52</sup> Robert K. Yin. *Case Study Research. Design and Methods* (5<sup>th</sup> ed. SAGE Publications, 2014) at 9.

<sup>53</sup> Yin, above n 52, at 10.

<sup>54</sup> Loraine Blaxter, Christina Hughes, and Malcolm Tight. *How to Research* (3rd ed, Open University Press, Berkshire, 2006) at 172.

<sup>55</sup> Zoltan Dornyei, *Research Methods in Applied Linguistics* (Oxford University Press, Oxford, 2007).

#### 5.4.2.2 Overview

According to Roulston,<sup>56</sup> there are three main types of interviews which are used in social-science research: structured interviews, semi-structured interviews and unstructured interviews. In structured interviews, or standardised interviews, an interviewer follows a predetermined set of questions, reading the questions as worded without adding or skipping anything. Structured interviews are usually applied in quantitative research in the form of surveys. Data extracted from structured interviews are used predominately for testing hypothesis.

In contrast to structured interviews, semi-structured and unstructured interviews are forms of non-standardised interviews allowing the interviewer more freedom in choosing the wording and the sequence of questions depending on the flow of the interview. Additional questions can also be asked to seek further clarification during semi-structured and unstructured interviews. Data extracted from these forms of interviews is mainly used for description and interpretation, and is analysed by means of inductive methods.<sup>57</sup>

An advantage of semi-structured interviews over unstructured interviews is that, unlike the free-flowing conversation format of unstructured interviews, semi-structured interviews are usually conducted following an interview guide, which represents questions or topics to be explored by the interviewer.<sup>58</sup> The existence of the guide allows the interviewer to achieve optimal use of the time allotted for an interview and to keep the interview focused on the main issues.<sup>59</sup>

Considering the limited amount of time available for each interview and the necessity in obtaining the desired information which would be sufficient for answering the research questions, semi-structured interviews were adopted as the data collection tool in this study.

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<sup>56</sup> Katherine Roulston *Reflective Interviewing: A Guide to Theory and Practice* (Sage, London, 2010) at 14-15.

<sup>57</sup> Roulston, above n 56.

<sup>58</sup> Barbara DiCicco-Bloom and Benjamin Crabtree “The qualitative research interview” (2006) 40 Medical Education 314 at 315.

<sup>59</sup> DiCicco-Bloom and Crabtree, above n 58, at 315.

#### 5.4.2.3 Sample Selection

One of the widely used sampling methods in qualitative research is purposive sampling.<sup>60</sup> The purposive sampling technique is a method in which participants are selected or sampled on the basis of their knowledge and experience with the subject of the problem being researched.<sup>61</sup> In contrast with probabilistic sampling applied in quantitative studies, purposive sampling is non-random technique which does not require the creation of a sample that is representative of the population from which this sample is drawn. Instead, the researcher determines what information needs to be gained and consequently searches for participants who are able, by virtue of their knowledge, experience and willingness, to provide this information.<sup>62</sup>

Accordingly, in line with the purposive sampling method, the interview participants in this study were selected from the following groups, which the researcher believed to possess knowledge about the cost of tax compliance of large enterprises in New Zealand and have experience in dealing with tax issues of large enterprises:

1. Tax practitioners of large chartered accountant firms
2. Chief Executive Officers (CEOs) and tax managers of large enterprises
3. IR officials

External tax practitioners were initially selected from the websites of the largest tax accountant firms in New Zealand (known as the “Big Four”), located in Christchurch, Wellington and Auckland. A covering letter, outlining the study and the purpose of the interviews was sent to those tax practitioners who were believed to have knowledge and experience in dealing with large enterprises in New Zealand, asking them to participate in an interview. However, only one response was received from a tax practitioner in Christchurch (where the researcher was based). Due to this being an ineffective way of approaching tax practitioners directly, it was decided to approach Chartered Accountants Australia and New Zealand (CA-ANZ), a professional body representing tax practitioners in Australia and New Zealand, for assistance in selecting and contacting tax practitioners on the researcher’s behalf. As result of this request,

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<sup>60</sup> Michael Patton *Qualitative research and evaluation methods* (3rd ed, Sage, Thousand Oaks, 2002).

<sup>61</sup> John Creswell and Vicki Clark *Designing and Conducting Mixed Methods Research* (Sage, Thousand Oaks, 2017).

<sup>62</sup> Ilker Etikan, Abukabar Sulaiman and Rukayya Alkassim “Comparison of Convenience Sampling and Purposive Sampling” (2016) 5 American Journal of applied and Theoretical Statistics 1 at 2.



CA-ANZ New Zealand Tax Leader, John Cuthbertson, suggested a list of practitioners who on a basis of their knowledge and experience would be the most appropriate candidates for an interview. The list included the names and contact details of eleven tax practitioners. Five of the tax practitioners were from accounting firms located in Auckland, four practitioners were from Wellington and the remaining practitioners were from Christchurch. This time a covering letter endorsed by the CA-ANZ New Zealand Tax Leader was sent out to all tax practitioners from the list. As result, four positive responses were received, among which two were from tax practitioners in Christchurch. A copy of the covering letter used to contact the tax practitioners is provided in Appendix 4 of the thesis.

It is worthwhile to note that each tax practitioner who agreed to participate in an interview held the position of a partner in their firm. This fact adds greater credibility to the responses provided by the tax practitioners, since as partners the tax practitioners have real-world experience in overseeing the tax matters of large enterprises in New Zealand and dealing with various complex tax issues.

With respect to contacting tax managers and CEOs of large enterprises, an attempt was made to approach them through the tax practitioners. To this end the tax practitioners were specifically asked if they could assist in arranging interviews with large enterprises (who were the tax practitioners' clients). However, only negative responses were received, explaining that for their clients' confidentiality they could not provide such assistance. Further attempts to contact a number of large enterprises (seven were contacted) directly by the researcher, asking if their tax managers and CEOs would be willing to participate in an interview, resulted in no positive responses.

In the researcher's opinion, one of the reasons why CEOs or tax managers were not responsive to the invitations to participate in the interview, is that they saw little benefit in the results of the current study for their organisations. The organisations which specialise in market research and have an extensive experience in interviewing CEOs and top managers of large organisations, indicate that in order to elicit a cooperation, CEOs and top managers need to feel that the feedback provided by the study will potentially effect change and result in improvements directly benefiting their firm.<sup>63</sup> In this regard, it is likely that the top

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<sup>63</sup> The Rockbridge "Executive Interviewing: How to Survey Hard-to-Reach Corporate Heads" (9 December 2013) < <https://rockresearch.com/executive-interviewing-how-to-survey-hard-to-reach-corporate-heads/> > (last accessed 16 July 2019).

management of the large enterprises contacted had little interest in the current study. The other possible reason why CEOs and tax managers did not respond positively to the invitation is that the cost of their time is very high. Due to time limitations it was decided not to pursue approaching tax managers and CEOs of large enterprises any further and therefore no interviews were conducted with this group for this study.

IR officials were contacted upon the recommendation of one of the tax practitioners from the list suggested by the CA-ANZ New Zealand Tax Leader. This effectively turned out to be the employment of a snowballing sampling method.<sup>64</sup> One of the contacted IR officials agreed to participate in an interview. A copy of the covering letter used to contact the IR official contained in Appendix 5 of the thesis.

#### *5.4.2.4 Development of the Interview Guide*

As mentioned in the subsection 5.4.2.2, semi-structured interviews use an interview guide to ensure that the interviews are conducted in a systematic manner and remain focused on the main subject of the investigation. Moreover, the use of an interview guide assists the researcher in managing the limited time allotted for an interview. Since the interviews were to be conducted with external tax practitioners and an IR official, two different interview guides were prepared as the majority of the content of the interviews with each group was intended to be different. While the interviews with the external tax practitioners were largely focused on the aspects of the cost of tax compliance of large enterprises in New Zealand, the interview with an IR official was aimed at gaining insights into how the IR monitors tax compliance in large enterprises. However, one commonality in the interviews with the external tax practitioners and the IR official is that both groups were asked to define large enterprises in New Zealand.

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<sup>64</sup> A nonprobability sampling method, where participants of the research recruit other participants for research. See Mahin Naderifar, Hamideh Goli and Fereshteh Ghaljaie “Snowball Sampling: A Purposeful Method of Sampling in Qualitative Research” (2017) 14 Strides in Development of Medical Education 1.

#### *5.4.2.4(a) Tax Practitioners' Interview Guide*

The development of the interview guide with the external tax practitioners was largely influenced by the research questions and the conceptual framework for the measurement of the costs of tax compliance. To recap, there are three research questions identified in this thesis:

*RQ 1. How can we define a “large enterprise” in New Zealand, if we want to study and measure its tax compliance costs?*

*RQ2. What are the magnitude, composition and drivers of tax compliance costs in large enterprises in New Zealand?*

*RQ3. How do large enterprises differ from SMEs in terms of the tax compliance activities and composition of tax compliance costs?*

Therefore, in order to address the research questions the interview guide was separated into two parts. The first part comprised a number of questions which were aimed at gaining an understanding of the tax practitioners' perspectives on the magnitude and composition of tax compliance costs in large enterprises in New Zealand. In addition, a question was specifically asked about how tax practitioners understand the concept of a large enterprise. Another question directly asked how much the particular tax practitioner's firm would charge for the preparation of a particular tax return for a large enterprise. Due to the potential unwillingness of tax practitioners to provide numbers for commercial and confidentiality reasons, the researcher realised that obtaining answers to this question from the interviewees might not be possible. However, it was decided to include this question in the interviews in the hope of obtaining at least ballpark numbers.

The second set of interview questions had the purpose of elucidating the tax practitioners' opinions about the causes of the tax compliance cost burden in large enterprises and the factors driving these costs. Initially it was intended to ask tax practitioners what suggestions they would make in order to simplify the current tax rules that affect large enterprises so that the costs of tax compliance in large enterprises could be reduced. However, due to the limited interview time, this question was omitted in the interviews conducted. A copy of the tax practitioners' interview guide is provided in the Appendix 2 of this thesis.

#### *5.4.2.4(b) IR Official's Interview Guide*

The interview with the IR official sought to obtain crucial information on how the IR defines large enterprises and also what approaches the IR uses to monitor the tax compliance of large enterprises in New Zealand. The information on the approaches the IR uses to monitor large enterprises was expected to provide insights for Chapter 4 of this thesis, which outlines the tax compliance of large enterprises in New Zealand. Therefore, the development of the interview guide for the IR official was influenced by these two goals. In comparison with the tax practitioners' interview guide, this guide is shorter and comprises only one set of questions. The first question asks how the IR defines large enterprises. The remaining questions ask what methods the IR applies to monitor the tax compliance of large enterprises, what are the basic tax compliance obligations of large enterprises, and what difficulties the IR experiences in monitoring the tax compliance of large enterprises. A copy of the interview guide with an IR official is contained in the Appendix 3 of this thesis.

#### *5.4.2.5 Sample Size*

When determining a sample size, the question arises as to what sample size is appropriate (effective) for undertaking a study. In the case of quantitative research, factors that determine effective sample size are usually the width of confidence intervals and population variance.<sup>65</sup> In regard to qualitative research, according to Patton,<sup>66</sup> there are no rules for determining the size of a sample. The goal of a research, the usefulness of information obtained and credibility of facts gathered determine how large a sample should be in qualitative research.<sup>67</sup>

Despite the absence of clear rules for establishing sample size in qualitative research, the concept of data saturation might be a helpful approach to determine the effective sample size. Saturation of data indicates that "... on the basis of the data that have been collected or analysed hitherto, further data collection and/or analysis are unnecessary".<sup>68</sup> Therefore, data saturation

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<sup>65</sup> Russel V Lenth "Some Practical Guidelines for Effective Sample Size Determination" (2001) 55 American Statistician 187.

<sup>66</sup> Patton, above n 60.

<sup>67</sup> At 244.

<sup>68</sup> Benjamin Saunders and others "Saturation in Qualitative Research: Exploring Its Conceptualization and Operationalization" (2018) 52 Quality & Quantity 1893 at 1893.

serves as the criterion for discontinuing further data collection as each new piece of data does not bring new information. According to Seale, a researcher who carries out a qualitative study and finds that each new instance (in this case, an interview) generates results similar to those they encountered earlier, can conclude that their data is saturated.<sup>69</sup>

Due to the fact that the present study uses qualitative approach, no plans were made in regard to the size of the sample at the outset of the study for the reasons explained above. The sample size was eventually determined on a basis of two following factors. First, despite a small sample size, after having interviewed five tax practitioners, the researcher noticed that a number of similar answers was received from each of them, indicating that the data saturation point may have been achieved. Second, as the number of “Big Four” senior staff in New Zealand is relatively small, interviewing more tax practitioners makes it highly likely that tax practitioners from the same firm will be interviewed. Moreover, given the relatively small size of the population of large enterprises in New Zealand,<sup>70</sup> gaining a new information (beyond what was already established in the literature) about the costs of tax compliance of large enterprises from interviewing more tax practitioners was considered to be unlikely. Consequently, it was decided not to interview more tax practitioners upon completion of the fifth interview.

In relation to the interview with an IR tax official, information provided by an IR official during the interview was based entirely on the official information released by the IR. Therefore, unlike external tax practitioners who provided the opinions of their firms when responding to the interview questions, the IR official’s responses were reflecting the IR position and were not based on their personal opinion. As the purpose of the interview was to gain an insight into how the IR defines large enterprises and what approach it applies to monitor their tax compliance in New Zealand, interviewing only one IR official was considered sufficient for this purpose.

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<sup>69</sup> Clive Seale *The Quality of Qualitative Research* (Sage, London, 1999).

<sup>70</sup> Based on IR figures, large enterprises comprise 0.2% of the total number of registered enterprises in New Zealand. See IR “Registered customers by groups 2008-2017” <<https://www.ird.govt.nz/aboutir/external-stats/customers/reg-by-customer-group/customers-reg-cust-by-groups.html>> (last accessed 23 December 2018).

#### 5.4.2.6 Data Collection

Interviews with the selected participants were conducted on a one-to-one basis, either face-to-face or over the telephone. Although interviews over the telephone have certain disadvantages compared to face-to-face interviews, including the inability to see nonverbal reactions of the participant,<sup>71</sup> telephone interviews were considered more convenient for the tax practitioners located in Auckland and Wellington. The interviews with the IR official and tax practitioners in Christchurch were conducted face-to-face.

Prior to the interview each participant was provided with an information sheet and consent form and was asked to sign and return the consent form by e-mail or in person. The information sheet contained an outline of the study, the reasons for conducting the interview and an explanation of the interview process. Both the consent form and information sheet requested the participants' permission to audio-record the interview and mentioned that the participants will be provided with a copy of the transcribed interview upon their request. Copies of the consent form and information sheet which were emailed to the tax practitioners and the IR official are provided in Appendices 6 and 7 of this thesis.

The interviews with the tax practitioners and the IR official took place between 20 February 2018 and 7 August 2018. The average interview time was 30 minutes.

#### 5.4.2.7 Ethical Considerations

The Human Ethics Committee (HEC) of the University of Canterbury requires all researchers, including students, whose research is related to dealing with human subjects, to obtain approval prior to commencing research. Accordingly an application was submitted to the HEC outlining the measures that would be taken to ensure confidentiality of the interview participants and how the transcribed interviews would be stored. The application also outlined that the participants' consent would be obtained through the signed consent form, as discussed in section 5.4.2.5 above. Approval from the HEC was received on 12 January 2018. The information sheet and the consent form provided to the interview participants indicated that

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<sup>71</sup> Mark Saunders, Phillip Lewis and Adrian Thornhill *Research Methods for Business Students* (5th ed, Prentice Hall, Harlow, 2009).

approval of HEC had been obtained. A copy of HEC approval letter is contained in Appendix 8 of this thesis.

#### *5.4.2.8 Data Analysis*

One of the methods used in the qualitative research to analyse data is thematic analysis, which represents the process of identifying themes or patterns within the data obtained in qualitative research. According to Braun and Clark,<sup>72</sup> thematic analysis is a useful method which equips the researcher with skills that can be applied in “many other kinds of analysis”.<sup>73</sup> Braun and Clark identify six phases for conducting thematic analysis:<sup>74</sup>

1. Becoming familiar with the data
2. Generating initial codes
3. Searching for themes (pattern in the data)
4. Reviewing themes
5. Defining themes
6. Writing report

In this study the data gathered from the interviews was analysed in line with thematic analysis following the six phases suggested by Braun and Clark<sup>75</sup>. However, due to the relatively small sample size, it was considered that the generation of codes would not be necessary. Therefore, the content of audio-recorded interviews was first transcribed and compiled into tables. Each table contained the responses provided by the interview participants to a particular question from the interview guide. The content of each table with the participants’ responses was then reviewed to identify interview themes for the subsequent analysis. Finally, the interview findings were summarised based on this analysis.

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<sup>72</sup> Virginia Braun and Victoria Clarke “Using Thematic Analysis in Psychology” (2006) 3 *Qualitative Research in Psychology* 77.

<sup>73</sup> At 81.

<sup>74</sup> At 87.

<sup>75</sup> At 87.

### *5.5 Conclusion*

In this chapter the conceptual framework which is widely applied in the literature on the measurement of the cost of tax compliance, was presented. In addition, the discussion was extended to incorporate the model of cost optimal tax administration based on the premise of the Theory of Rational Choice. This model can assist in the estimation of the unobservable costs of tax compliance which influences the gross costs of tax compliance as this group of costs arises due to inefficient tax compliance practices.

The chapter then outlined the methodological approach employed in this study of exploratory analysis, which features both exploration (making new findings) and confirmation (comparison with prior studies). The conceptual framework and the model of cost efficient tax compliance administration serve as the guidance based on which the researcher will explore the magnitude, composition and determinants of the cost of tax compliance of large enterprises in New Zealand.

In line with exploratory analysis, semi-structured interviews were used in this study as the main data collection method. Accordingly, this chapter has discussed the features of semi-structured interviews, as well as other aspects such as development of the interview guide, sample selection, sample size, data collection and data analysis procedures related to the implementation of semi-structured interviews. Chapter 6, which follows, will present the findings from the semi-structured interviews.



## **Chapter 6: Semi-Structured Interviews with Tax Practitioners and an IR Official**

### *6.1. Introduction*

This chapter provides the results of the interviews conducted with the New Zealand tax practitioners and an Inland Revenue (IR) official on the costs of tax compliance of large enterprises in New Zealand. The purpose of the interviews was to find out how tax practitioners and the IR understand the concept of a large enterprise and to elucidate tax practitioners' opinions on the magnitude, composition and determinants of the costs of tax compliance of large enterprises. Findings from the interviews were analysed in order to draw inferences aimed at addressing the research questions outlined in Chapter 1 of this thesis. Accordingly, the structure of this chapter is as follows. Section 6.2 provides information about the interview participants in respect of their gender, occupation, position and their association with professional bodies. An outline of the participants' responses along with an analysis of their responses is provided in section 6.3. The findings from the interviews are then summarised in section 6.4

### *6.2. Participants in the Interviews*

As mentioned in Chapter 5 (in sections 5.4.2.3 and 5.4.2.4) the majority of tax practitioners were recruited from a list provided by the New Zealand Tax Leader of Chartered Accountants Australia and New Zealand (CA-ANZ). The list included the names and contact details of 11 tax practitioners from Auckland, Wellington and Christchurch. All of the tax practitioners from the list were contacted by the researcher through e-mail and four gave positive replies. One more tax practitioner, whose name was not on the list, was recruited by the researcher through direct contact.

An IR official was also recruited through an e-mail sent by the researcher as the result of a recommendation made by one of the tax practitioners from the list provided by the CA-ANZ New Zealand Tax Leader. Ultimately, six participants took part in the interview, comprising five tax practitioners from large chartered accountant firms in Auckland, Wellington and Christchurch, and an IR official from Christchurch.

Table 6.1 below presents information regarding the interview participants. All five tax practitioners were members of CA-ANZ. In addition to belonging to CA-ANZ, one of the tax practitioners was a member of the New Zealand Law Society (NZLS) and another two tax practitioners were members of the Institute of Directors in New Zealand. One tax practitioner was also an accredited member of the International Fiscal Association (IFA). As for their positions, four of the tax practitioners were working in their firms in the position of partner and one tax practitioner was a director. The IR official was also a member of CA-ANZ and was working as a tax specialist in the IR.

**Table 6.1: Participants in the interviews**

<b>Participant as coded in the thesis</b>	<b>Gender</b>	<b>Position and occupation</b>	<b>Accreditation with professional body</b>
Tax Practitioner 1	Male	Partner, tax and legal advisor	CA-ANZ, NZLS
Tax Practitioner 2	Male	Partner, tax advisor	CA-ANZ, Institute of Directors in New Zealand
Tax Practitioner 3	Male	Partner, tax advisor	CA-ANZ
Tax Practitioner 4	Male	Partner, tax advisor	CA-ANZ, Institute of Directors in New Zealand
Tax Practitioner 5	Female	Director, tax advisor	CA-ANZ, IFA
IR Official	Male	Tax Specialist	CA-ANZ

### *6.3. Interview Results*

Due to time limitations, the questions for the tax practitioners regarding their suggestions for reducing the cost of tax compliance in large enterprises, and whether in their opinion, large enterprises followed cost efficient tax compliance administration, were omitted. In addition,

although the interview with the IR official covered areas such as the methods that the IR applies to monitor tax compliance of large enterprises and the basic tax obligations of large enterprises, only the part of the interview which concerns the definition of large enterprises is presented in this chapter. The reason for including only this part of the interview with the IR official is that it is most relevant for addressing the research questions. Further, in regard to the quality of responses provided by the tax practitioners, it was expected they would be more concise in their content. However, despite this limitation, the interviews with both the tax practitioners and the IR official resulted in satisfactory information for addressing the research questions outlined in Chapter 1 of this thesis. While some of the tax practitioners could offer only general information, their answers nonetheless allowed the researcher to form a basis for making conclusions. The responses of the participants and an analysis of their responses are provided below.

### *6.3.1 Definition of Large Enterprise*

#### *6.3.1.1 Tax Practitioners' Perspectives*

The first question asked during each of the interviews was how tax practitioners understand the concept of large enterprises to apply in New Zealand. It should be noted that in responding to this question, the tax practitioners offered their personal perspective on the definition of large enterprises and not the perspective of their firms.

Analysis of the responses of the tax practitioners to this question revealed that there is no common understanding amongst tax practitioners as to what comprises a large enterprise in New Zealand. Each of the tax practitioners interviewed provided their own criteria which, in their minds, were most appropriate for describing what a large enterprise is. Table 6.2 contains excerpts from the practitioners' responses. The tax practitioners in Table 6.2 (and in the remaining tables in this chapter) have been coded as indicated in Table 6.1 above (as Tax Practitioners 1, 2, 3, 4 and 5).

**Table 6.2: How tax practitioners define large enterprise in New Zealand**

<b><i>Tax</i></b> <i>Practitioner 1</i>	“I guess you could measure it by turnover, you can measure it by profit or by amount of tax firm pays like for example payroll tax.... It is all depends on how you want to define it...from my perspective we would probably look at turnover, size and complexity”.
<b><i>Tax</i></b> <i>Practitioner 2</i>	“It is [...] in the eye of the beholder ... My preference is that of financial reporting standards. A very large enterprise defined by the standards of financial reporting will be the one that got assets in excess of NZ\$30 million, NZ\$ 60 million in revenue, lower for the overseas [enterprises]...”.
<b><i>Tax</i></b> <i>Practitioner 3</i>	“An entity with turnover of NZ\$100 million. One of the feature of a large enterprise is having a tax manager on board...”.
<b><i>Tax</i></b> <i>Practitioner 4</i>	“Well by large enterprises I normally understand an enterprise with a NZ\$100 million turnover...i.e. it is the IR approach. Also, one can use a threshold of NZ\$30 million, but it will rather apply to foreign owned enterprises...”.
<b><i>Tax</i></b> <i>Practitioner 5</i>	“Various criteria can be applied here... for example for a very large multinational it is NZ\$1.3 billion turnover, NZ\$80 million dollars for domestic enterprise or NZ\$30 million for foreign owned. Also a large number of employees can characterise an enterprise as large”.

As can be seen from Table 6.2, although the majority of the tax practitioners were referring in their answers to the thresholds established by the IR or the Financial Reporting Act 2013 (FRA 2013) for defining large enterprises, each tax practitioner had their own idea of what a large enterprise in New Zealand might look like. Obviously, tax practitioners apply certain criteria to define a large enterprise according to their professional requirements, which may depend on the particular client for whom they provide a service. The fact that each of the tax practitioners interviewed used different thresholds and benchmarks to define a large enterprise might indicate that there is no established concept of a large enterprise among tax practitioners in New Zealand. Nevertheless, while some of the criteria cited by Tax Practitioners 3, 4 and 5 are similar (the IR criterion of NZ\$100 million and NZ\$30 million), their responses still demonstrate that they differ in what thresholds to use to define large enterprises.

Notably, Tax Practitioner 3 was the only participant who used qualitative characteristics to define a large enterprise – the presence of a tax manager in an organisation. During the interview, Tax Practitioner 2 mentioned that they use “quantitative criteria, because generally quantitative criteria are readily ascertainable”. This points to the fact that both qualitative and quantitative criteria can be applied to define large enterprises. However, tax practitioners prefer

to rely on quantitative criteria as it is much easier to describe the size of an organisation using numerical values.

#### *6.3.1.2 An IR Official's Perspective*

Unlike the responses of the tax practitioners which reflected their personal opinions on how they define large enterprises in New Zealand, the IR tax official's responses were based completely on the official interpretation of the IR of what enterprises are considered to be large in New Zealand.

Although some of the thresholds that the IR applies to designate large enterprise were presented in Chapter 3 of this thesis, the interview with the IR official provided additional information in regard to how the IR classifies large enterprises in New Zealand. Based on the interview, the remainder of this section summarises the IR current stance on the classification of large enterprises in New Zealand.

Currently the IR no longer officially uses the term “large enterprise” for monitoring tax compliance, but instead uses the new term of “significant enterprise”. As explained in Chapter 3, section 3.1, of this thesis, a NZ\$100 million turnover threshold is used to designate large enterprises in the context of customer service function of the IR and includes a number of tax exempt organisations such as Government departments. These tax exempt organisations are not a part of the IR core compliance population.<sup>1</sup>

There is a unit within the IR structure known as the “significant enterprises customer segment” which monitors the tax compliance issues of significant enterprises. The IR defines a significant enterprise as a taxpayer group (whether a single enterprise or a group of enterprises) with more than 50 employees, or with an annual Goods and Services Tax (GST) turnover above NZ\$80 million for New Zealand-owned enterprises, and NZ\$30 million for foreign-owned enterprises. During the interview, the terms “significant enterprises” and “large enterprises” were used by the IR official almost interchangeably for taxpayer groups with an annual GST turnover above NZ\$80 million. Further clarification by the IR official revealed that the IR considers taxpayer groups with an annual turnover greater than or equal to NZ\$80 million as “large enterprises”. However, this term is not officially used for the purposes of monitoring tax

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<sup>1</sup> Email from Stephen Casey (International Revenue Strategy team) to the researcher regarding the definition of large enterprises in New Zealand (25 September 2018).

compliance. According to the IR official there are approximately 600 taxpayer groups that can be labelled as “large enterprises”.

The interviewer sought to clarify how the IR treats New Zealand-owned enterprises when the number of employees is less than 50 and the annual turnover is greater than NZ\$30 million but less than NZ\$80 million. The IR official responded:

It will certainly be included in significant enterprises, we will deal with it in a same way as we deal with a large enterprise, but if it is below \$30 million than we will classify it as small and medium enterprise. If they is just below \$80 million threshold they generally get treated the same way, but if they are below \$30 million they fall into category of small to medium. There is no much difference for the top range, there is difference for the lower range.

A follow-up by e-mail to the interview with the IR official, which occurred four months after the interview took place, further clarified that currently enterprises which have an annual GST turnover in excess of NZ\$30 million will be included in the significant enterprises segment and be treated accordingly. Obviously, in such a case, it is irrelevant whether such an enterprise is foreign-owned or New Zealand-owned. Based on the additional information provided by the IR official in the follow up email, inclusion of enterprises with annual GST turnovers of less than NZ\$80 million but greater than NZ\$30 million will increase the number of taxpayer groups in the significant enterprises segment to 930.

Therefore, from the information provided during the interview and the follow-up email, the following conclusion can be drawn regarding how the IR classifies large enterprises and Small and Medium Enterprises (SMEs):

- **SME**

Less than 50 employees or an annual GST turnover of less than NZ\$30 million

- **Significant Enterprises**

More than 50 employees or an annual GST turnover of more than NZ\$30 million

- **Large Enterprises (within classification of significant enterprises)**

An annual GST turnover of more than NZ\$80 million

With the confirmation provided by the IR official following the interview,<sup>2</sup> one of the criteria that must be fulfilled for an enterprise to move from the SMEs category to the category of significant enterprises is the number of employees or an annual GST turnover. For instance, if an enterprise has an annual GST turnover of NZ\$ 25 million, but at the same time the number of its employees is over 50, then this enterprise will be considered “significant”, as one of the criteria is fulfilled. In the same vein, an enterprise with 30 employees, but which annually generates more than NZ\$ 30 million of GST turnover, will also be classified as “significant”.

As indicated above, the IR does not apply qualitative characteristics in its new classification to define large enterprises but uses numerical criteria such as a number of employees and GST turnover. Notable, the number of employees that the IR applies as a metric to measure whether an enterprise is significant (and large if its turnover exceeds NZ\$ 80 million) is half the number of employees which New Zealand Ministry of Business, Innovation & Employment (MBIE) uses to define large enterprises.<sup>3</sup> This fact once again emphasises that different stakeholders (the IR and MBIE) may apply different thresholds to define large enterprises despite using the same criterion (number of employees).

### *6.3.2 The Magnitude and Composition of Tax Compliance Costs in Large Enterprises*

This section contains an analysis of the replies provided by the tax practitioners to various questions concerning the magnitude and composition of the tax compliance costs in large enterprises.

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<sup>2</sup> Email from the IRD official to the researcher regarding the definition of significant enterprises in New Zealand (2 July 2019).

<sup>3</sup> MBIE define large enterprises as those with more than 100 employees. See MBIE “The small business sector report” (2014) at 10.

### 6.3.2.1 Magnitude of Tax Compliance Costs

In order to obtain information regarding the magnitude of tax compliance costs in large enterprises, each of the tax practitioners was asked the following question:

*“Can you give the fee range that you would charge a large enterprise for the preparation of a tax return?”*

The answers to this question are reproduced in Table 6.3:

**Table 6.3: How much tax practitioners would charge large enterprises for the preparation and review of tax return**

<i><b>Tax</b> Practitioner 1</i>	<p>“Depends on the amount of work done in house by a large enterprise. Large enterprises should have resources. They may do 90-99% themselves and then just ask us to do a high level safe-check of their numbers. So the fee range can be from a few thousand dollars if everything is done in house and submitted to us or if everything is outsourced to us the range might get up to NZ\$50,000”</p> <p><b>Question: Do all large enterprises do 90% of work in house and then ask you to check or how does it normally happen in large enterprises?</b></p> <p>“So in my experience the most common pattern is somewhere in the middle, where in house personal would do all the calculations and prepare all the numbers and we will do detailed review”</p>
<i><b>Tax</b> Practitioner 2</i>	<p>“It will be based on the complexity of calculations. So for example a multinational that has a multinational exposure would take a significant amount of time and they will also carry some amount of risk and so the fee will be complexity and risk basis associated in this particular return. It depend on what else we will be doing and how much work is being done by the company internal resources as well. In some cases in might be a straightforward tax return and it might be 3-4 thousand dollars and in other cases it might be 10-15 thousand dollars tax return it will also depend on if there is more or less advice...”</p>
<i><b>Tax</b> Practitioner 3</i>	<p>“Usually we do tax review only. Pricing is based on the complexity of tax return, say cross-border transactions or CFC or FIF affects the complexity. Our review fee is based on hourly rate of NZ\$750 and above”.</p>
<i><b>Tax</b> Practitioner 4</i>	<p>“It is very difficult to tell the number as everything is determined by the complexity, type of tax and a case. For example, such elements as transfer pricing and operating in other jurisdictions can significantly affect complexity”.</p>
<i><b>Tax</b> Practitioner 5</i>	<p>“We mostly do reviews of tax return, as preparation is done by large enterprises internally. Reviews can range from NZ\$2,000 –NZ\$20,000. Much work will be involved if uncertainly about deductibility or figuring depreciation rates exist”.</p>



As the question about the fee range was asked to tax practitioners from different accounting firms, a relatively wide range of fees that might be charged to a large enterprise for the preparation or review of tax returns was received. It should be noted that most of tax practitioners indicated that the majority of large enterprises in New Zealand prepare their tax returns internally and they require tax practitioners to review the return before it is filed. Therefore, the fees that were mentioned by the tax practitioners were predominantly fees charged for reviewing the internally-prepared tax returns of large enterprises. According to the numbers provided in the interviews, a large enterprise in New Zealand might be charged in the range of NZ\$2,000 to NZ\$20,000 for the review of its tax return, depending to a great degree on the complexity of the tax return.

It is very likely that large enterprises would ask external tax practitioners for their help for tax advice in relation to business structure, a particular transaction, and tax planning. However, all of the tax practitioners responded to the question about the fee range for these kind of services by only saying that it would depend on the industry within which the large enterprise operates and the complexity of the advice. An hourly rate of NZ\$750 quoted by Tax Practitioner 3 might suggest that the cost to a large enterprise for tax advisory and tax planning could be sizable.

#### *6.3.2.2. Composition of Tax Compliance Costs*

As the interviews were conducted with external tax practitioners and not with large enterprises themselves, the information about the composition of tax compliance costs in large enterprises is limited to the information regarding the types of services that tax practitioners provide for their respective clients (large enterprises). Thus, it is difficult to form an opinion about the total composition of tax compliance costs in large enterprises based on these interviews alone. Moreover, the nature of the information obtained during the interviews does not allow inferences to be made about the composition of tax compliance costs in large enterprises in percentage terms. Most of the tax practitioners found it difficult to answer what percentage of each type of service they provided among all the services that they provided to their clients. Nevertheless, the responses from the tax practitioners might provide an idea of which types of services large enterprises are more likely to purchase from external tax practitioners.

Tax Practitioner 1 responded that the services their firm provides to large enterprises include:

1. Income tax returns, Fringe Benefit Tax (FBT), GST and pay as you earn (PAYE) tax - although it was not confirmed whether it was preparation of these returns or their review;
2. Income tax planning and advisory regarding overseas transactions, mergers and acquisitions;
3. Dealing with the IR's claims and notices; and
4. Consulting in relation to tax structure.

Following the interview with Tax Practitioner 1, an attempt was made to contact Tax Practitioner 1 by e-mail<sup>4</sup> in order to ask them to clarify whether the services provided by their firm in regard to the Income tax, FBT, GST and PAYE were preparation or reviews of these taxes. However, Tax Practitioner 1 did not provide any response to this request.

Tax Practitioner 2 mentioned that large enterprises would usually purchase the following services:

1. Income tax return preparation (although most of this work is done internally);
2. Income tax return review;
3. Tax advisory relating to the tax treatment of particular transactions (major acquisitions, doing business in a foreign jurisdiction) as well as advisory in relation to thin capitalisation and transfer pricing regimes requirements; and
4. Responding to the IR's request for additional information.

Among the services provided to large enterprises by the accounting firm of Tax Practitioner 3, were the following services:

1. Preparation of income tax returns, tax planning and tax advice;
2. Tax advisory relating to transfer pricing and particular complex transactions (the tax practitioner did not mention what kind of transactions); and
3. Due diligence and employee stock option planning.

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<sup>4</sup> Researchers' e-mail to Tax Practitioner 1 (26 October 2018).

Tax Practitioner 4 replied that usually their firm provide the following services to large enterprises:

1. Income tax return reviews;
2. Complex advisory services such as transfer-pricing;
3. Support in resolving issues related to customs; and
4. Installation of special accounting technology (software) in large enterprises and the training of a large enterprise's staff to use and maintain this technology.

Tax Practitioner 5 mentioned the following type of services:

1. Review of tax returns (42% of all the services provided);
2. Assistance in business structuring; and
3. Tax planning services.

One particular feature that can be inferred from the responses above is that the bulk of the services provided by external tax practitioners to large enterprises concerns income tax services. Income tax reviews, tax advisory in regard to transfer pricing, thin capitalisation, business structuring and overseas transactions, assist large enterprises in filing correct and accurate income tax forms (IR4 and IR10), and also to submit correct Basic Compliance Package (BCP). It is not surprising that income tax services were mentioned by all of the tax practitioners. Income tax is the most complex type of tax and, as shown in Chapter 4, the business activities of large enterprises often trigger various tax regimes. This significantly increases the complexity of the calculation of the taxable income of large enterprises.

As illustrated by the responses provided in Table 6.4 below, working on the income tax issues of large enterprises does indeed take up a significant proportion of the total time that tax practitioners spend on providing services to large enterprises.

**Table 6.4: Most time-consuming types of tax for tax practitioners**

<b><i>Tax</i></b> <i>Practitioner 1</i>	“I guess income taxes would take most of my time specially. It depends on whether are many changes in the national tax going on at the moment, like BEPS initiative..”.
<b><i>Tax</i></b> <i>Practitioner 2</i>	“If you focus on large enterprises they by definition will normally have their own finance function resources and therefore they will generally be doing their own GST returns. We will be focused on providing external advisory services in regard to particular transaction. Also large enterprises may want to have their income tax return prepared externally so that they know that their workings will be reviewed and that their workings results guarantee correct return”.
<b><i>Tax</i></b> <i>Practitioner 3</i>	“Income tax would probably be most time consuming due to complexity. The large the entity is the greater the complexity and the greater the risk of mistake.....”.
<b><i>Tax</i></b> <i>Practitioner 4</i>	“Income tax is most time consuming, cross –border transactions add much to the complexity...”.
<b><i>Tax</i></b> <i>Practitioner 5</i>	“Income tax return. There is very little work to do about GST, Payroll and FBT, as these are done internally”.

Without a proper quantification of the external tax compliance expenses and a breakdown of these expenses by the type of services provided, it is very difficult to say how much large enterprises in New Zealand spend on external preparation, review, tax advice, tax planning, audit and litigation relating to income tax. However, the following two facts suggest that the expenses on income tax services provided by external tax practitioners may account for the largest proportion of the total external tax compliance expenses of large enterprises in New Zealand. First, based on the tax practitioners’ responses, it would appear that large enterprises require services in connection with their income tax issues more often than services relating to other type of taxes. Second, as the responses in Table 6.4 suggest, dealing with large enterprises’ income tax issues does indeed make up a significant portion of tax practitioners’ time. This is compatible with the results of the studies by Slemrod and Blumenthal,<sup>5</sup> and Evans, Lignier and Tran-Nam,<sup>6</sup> on the tax compliance costs of large corporations in the United States (US) and Australia, respectively. Approximately 72% of the total cost of external tax services of large

<sup>5</sup> Joel Slemrod and Marsha Blumenthal “The Income Tax Compliance Cost of Big Business” (1996) 24 Public Finance Quarterly 411.

<sup>6</sup> Chris Evans, Philip Lignier and Binh Tran-Nam “Tax Compliance Costs of Large corporations: An Empirical Inquiry and Comparative Analysis” (2016) 64 Canadian Tax Journal 751.

US corporations were related to corporate tax services,<sup>7</sup> while the expenditures on all types of external services that related to income tax in large Australian corporations were more than 60% of the total external costs.<sup>8</sup>

Based on the responses provided by the external tax practitioners and the findings in the literature, it is possible to assume that large enterprises, including those in New Zealand, may have a comparably similar composition of external tax compliance costs, with expenses on income tax being the largest category of external tax compliance costs (more than 50%).

As mentioned at the beginning of this subsection, conducting interviews with only external tax practitioners is the main limitation of this research. For a fuller picture of the composition of the tax compliance costs (including the internal costs of tax compliance) of large enterprises in New Zealand, conducting interviews with tax managers and Chief Financial Officers (CFOs) of large enterprises would be helpful. In addition, undertaking a survey among a sample of large enterprises would also allow information on internal cost of tax compliance to be obtained. Moreover, conducting a survey among large enterprises would help to quantify the external expenses and possibly confirm the findings from these interviews.

#### *6.3.2.3 Factors Influencing the Magnitude of Tax Compliance Costs*

A number of factors might contribute to the magnitude of the costs of tax compliance in large enterprises. The literature on tax compliance costs identifies two main methods of determining the factors driving the costs of tax compliance: statistical analysis, and questionnaires or interviews. Statistical analysis helps to identify the determinants of tax compliance costs and quantify their effect. Slemrod and Blumenthal<sup>9</sup> identified, through statistical regression, four potential factors which affect tax complexity and hence the costs of tax compliance of the largest US corporations:

- size of an enterprise;
- type of industry an enterprise operates within;
- breadth of activity; and

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<sup>7</sup> Slemrod and Blumenthal, above n 5, at 423.

<sup>8</sup> Evans, Lignier and Tran-Nam above n 6, at 779.

<sup>9</sup> Slemrod and Blumenthal, above n 5, at 425.

- number of taxes

Questionnaires and interviews serve to identify factors contributing to tax complexity perceived by participants. Evans, Lignier and Tran-Nam <sup>10</sup> utilised a questionnaire to identify a number of other potential factors which were perceived by tax executives of large Australian corporations as the main drivers of tax compliance costs:

- complexity of the tax law;
- frequency of changes in tax rules;
- existence of international operations and cross-border transactions;
- duration and cost of tax disputes resolutions; and
- complexity of commercial transactions

In this present study, the tax practitioners interviewed were asked the following question in order to obtain their perceptions on the possible factors that may drive the cost of tax compliance in large enterprises in New Zealand:

*“In your opinion, what are the main factors driving cost of tax compliance in large enterprises?”*

The responses from the tax practitioners to this this question are provided below in Table 6.5:

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<sup>10</sup> Evans, Lignier and Tran-Nam, above n 6, at 785 and 786.

**Table 6.5: Perceived drivers of tax compliance costs in large enterprises**

<b>Tax</b> <i>Practitioner 1</i>	So, so, I think, complexity will be the main factor to drive costs up, this is more in relation to advisory services. In term of compliance, I think big factor here ten years ago the compliance process and the steps that organisation would take to prepare income tax return, GST, payroll was all furnished somewhere, whereas today people are really looking at structure at how they beat the tax more instead of compliance functions. By spending money upfront on the technology and getting better processes, automation, it is easy to get systems that can help bring compliance costs down.”
<b>Tax</b> <i>Practitioner 2</i>	n/a
<b>Tax</b> <i>Practitioner 3</i>	“I think it is the IR audit, because it requires preparation of a lot of documentation and therefore the cost of tax compliance might soar up....”.
<b>Tax</b> <i>Practitioner 4</i>	“Cost of penalties might be very high... Cost of disputes with the IR...”.
<b>Tax</b> <i>Practitioner 5</i>	“I think frequently changing tax regulation is the culprit of rising cost of tax compliance. More than 300 pages of new tax legislation every year...”. “A lot of changes in relation to BEPS... 76 pages.”

It should be noted that the reason why Table 6.5 does not include the response from Tax Practitioner 2 is that the question about drivers of tax compliance costs was inadvertently skipped by the researcher during the interview with Tax Practitioner 2. The researcher made an attempt to contact Tax Practitioner 2 by e-mail<sup>11</sup> after the interview had taken place; however, Tax Practitioner 2 did not respond to the researcher’s request for clarification.

From the answers provided by the other four tax practitioners, four factors can be identified as driving the cost of tax compliance in large enterprises:

1. Complexity
2. IR audits
3. Penalties
4. Frequently changing tax regulation

The complexity factor mentioned by Tax Practitioner 1 was not elaborated upon during the interview. However, the fact that it was “... more in relation to advisory services” suggests that

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<sup>11</sup> Researcher’s email to Tax Practitioner 2 (4 November 2018).

Tax Practitioner 1 was probably referring to the complexity of advisory services. The complexity of advisory services provided to large enterprises may depend on factors such as: size of business operations, complexity of transactions and the existence of cross-border or overseas operations and business structuring. Tax Practitioner 1 further mentioned that, in their opinion, the tax compliance activity itself (presumably that undertaken internally) is not a driving force behind the cost of tax compliance:

In term of compliance, I think big factor here...ten years ago the compliance process and the steps that organisation would take to prepare income tax return, GST, payroll was all furnished somewhere, whereas today people are really looking at structure at how they beat the tax more instead of compliance functions.

This answer may suggest that for large enterprises in New Zealand, the main determinants of tax compliance costs are probably not connected with tax compliance activities, but rather with endogenous factors such as the complexity of the business operations carried out by the large enterprise or business restructuring which large enterprise undertakes to “beat the tax”.<sup>12</sup> Moreover, according to Tax Practitioner 1, by installing automated processes to deal with tax compliance functions internally, large enterprises can “get systems that can help bring compliance costs down”.

The other three factors (IR audits, penalties and frequently changing tax rules) mentioned by Tax Practitioners 3, 4 and 5 as driving forces behind the cost of tax compliance in large enterprises, are compatible with the perceived factors in Evans, Lignier and Tran-Nam’s Australian study.<sup>13</sup> In relation to the frequently changing tax rules mentioned by Tax Practitioner 5, the new BEPS initiatives (as discussed in Chapter 4 of this thesis) may be one of the main factors contributing to the tax compliance costs of large enterprises. A number of transactions carried out by large enterprises may be caught by the recently adopted BEPS initiatives,<sup>14</sup> thereby increasing the complexity of the tax treatment of these transactions and further contributing to the cost of tax advice related to this tax treatment. Furthermore, Hoppe

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<sup>12</sup> It is most likely that by “to beat tax” Tax Practitioner 1 means adopting a legal tax strategy that allows large enterprises to minimise their tax payable.

<sup>13</sup> Evans, Lignier and Tran-Nam, above n 6, at 786.

<sup>14</sup> See Chapter 4, subsection 4.3.1 of this thesis, for these factors.



and others,<sup>15</sup> in their study on the drivers of tax complexity among multinational enterprises, found through a survey among 221 external tax practitioners from 108 countries (including New Zealand) that frequently changing tax regulation was the second most relevant complexity driver (excessively detailed tax regulation being the first) in the case of multinational enterprises. The BEPS developments are cited by Hoppe and others as one of the factors contributing to the frequency of changes in tax regulation.<sup>16</sup> Therefore, the response provided by Tax Practitioner 5 on frequently changing tax rules being a tax compliance costs driver is in line with the findings in the literature.

One of the factors that is likely to contribute to the costs of tax compliance in large enterprises in New Zealand is the existence of overseas operations or operating in foreign jurisdictions through a CFC. Blumenthal and Slemrod<sup>17</sup> measured the effect of worldwide presence on the costs of tax compliance of the largest US corporations. It was found that there is a pronounced effect on the increase in the costs of tax compliance when large US corporations operated in foreign jurisdictions. Accordingly, in this current study, the tax practitioners were asked the following question in order to seek their opinions on the effect that overseas operations and the existence of CFCs have on the costs of tax compliance in large enterprises:

*“In your experience, do cost of tax compliance change significantly, if a large enterprise has overseas subsidiaries (CFC) or investments in foreign entities (CFC or FIF) or simply engages in cross-border transactions?”*

Table 6.6 below presents their responses to this question:

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<sup>15</sup> Thomas Hoppe and others “What Are the Drivers of Tax Complexity for Multinational Corporations? Evidence from 108 Countries” (WU International Taxation Research Paper Series No. 2017-12, 2017).

<sup>16</sup> At 10.

<sup>17</sup> Marsha Blumenthal and Joel B Slemrod “The Compliance Cost of Taxing Foreign-Source Income: Its Magnitude, Determinants, and Policy Implications” (1995) 2 International Tax and Public Finance 37.

**Table 6.6: Does the existence of CFCs or overseas transactions affect tax compliance costs in large enterprises?**

<b>Tax</b> <i>Practitioner 1</i>	<p>“Yes, it does. Part of it would be that in-house team won’t have experience with the overseas jurisdiction and so for New Zealand tax, tax compliance cost is the time spent by the in-house team, while for overseas operation you have to rely more on advice. So if you look at the costs it does not necessarily increase the cost, it is just either internal costs or external costs. But there is complexity to determine whether CFC is active or passive...then there is cross-border transfer pricing requirements, thin capitalization issues. There are always additional things to do”.</p>
<b>Tax</b> <i>Practitioner 2</i>	<p>“Well yes, if we talk about cross border transactions we mean just selling overseas. They don’t have permanent establishment. Say for example New Zealand business is exporting to Australia and distributing through the third party, its independent distributor, there. They may have GST exposure in Australia in that situation but generally they don’t have income tax obligations there if they don’t have PE in Australia. As soon as you’ve got PE, say you are operating through a branch of New Zealand entity, or you are operating through a subsidiary – dependent distributor. Then all the sudden the door opens and the transfer pricing issues appear and people want to get an advice on how to minimise their global tax, what appropriate structures to have in place whatever mechanism that could be used like transfer pricing. Even so, even for private individual who may have foreign business the cost of doing income tax calculation may be significant, because unless he goes through financial advisor management system, he will need to spend a lot of money figuring out where his money is coming from.</p> <p>I have worked for one private individual who had 20 million investment in overseas portfolios and interests, and it might be 5 grands a year just to work out what his tax is because of all the calculation you need to make. Well it was just a private individual ...imagine if we have a large enterprise that has CFC, FIF, whatever, that where it becomes complex.... and particularly how the imputation system works ....so the answer is yes”.</p>
<b>Tax</b> <i>Practitioner 3</i>	<p>“Yes they do, CFC rules are very complex especially in the context of multinationals. Engaging in cross-border transactions may often require the knowledge about other jurisdiction as well as transfer pricing issues. All these aspects pose significant risks and require our review of tax return very often”.</p>
<b>Tax</b> <i>Practitioner 4</i>	<p>“There is no big difference between SME and large enterprises in this regard. The main driving factor of costs here is the uncertainty of interpretation of tax rules and disputes with the IR”.</p>
<b>Tax</b> <i>Practitioner 5</i>	<p>“They definitely do, but not necessarily from the perspectives of New Zealand taxation. Very often it can be tax laws of the other jurisdiction”.</p>

From the responses provided in Table 6.6, it is possible to conclude that the existence of a CFC or engaging in overseas operations, does indeed increase the costs of tax compliance in large enterprises. The costs of tax compliance increase due to increased complexity from the CFC regime as it requires complex calculations and knowledge of the CFC rules in order to determine whether a CFC is an active or passive CFC. According to the response from Tax

Practitioner 1, for tax matters relating to overseas jurisdictions, overseas transactions, CFCs, transfer pricing and thin capitalisation, large enterprises have to seek the assistance of external tax practitioners as their internal staff usually do not have the knowledge to deal with such complex situations:

In-house team won't have experience with the overseas jurisdiction and so for New Zealand tax, tax compliance cost is the time spent by the in-house team, while for overseas operation you have to rely more on advice.

Therefore, if a large enterprise has a CFC or has to deal with other cross-border regimes, this will not necessarily increase the internal cost of tax compliance. However, it is likely to increase the external costs as a complex tax situation caused by the CFC or other cross-border regimes will require more work and special knowledge from tax practitioners.

The existence of a CFC or foreign operations may also increase the costs of tax compliance as a large enterprise may seek the advice of tax practitioners on how to structure the group business in order to minimise the global tax that the large enterprise will face in New Zealand and in other jurisdictions. According to Tax Practitioner 2:

...Then all the sudden the door opens and the transfer pricing issues appear and people want to get an advice on how to minimise their global tax, what appropriate structures to have in place whatever mechanism that could be used like transfer pricing.

The response provided by Tax Practitioner 3 confirms the already mentioned fact of complexity which the CFC or transfer-pricing regimes bring in, and that dealing with these regimes requires specialist knowledge. Moreover, Tax Practitioner 3 mentions that the existence of a CFC or engaging in overseas transactions poses significant risks, and that tax returns prepared by large enterprises internally will often require these returns to be reviewed by external tax practitioners. Therefore, increased tax risks from having a CFC or engaging in cross-border operations may also be a driving force of the costs of tax compliance in large enterprises.

Tax Practitioner 4 responded by saying that:

The main driving factor of costs here is the uncertainty of interpretation of tax rules and disputes with the IR.

This implies that uncertainty of interpreting tax rules concerning the CFC regime and overseas transactions might result in disputes with the IR, thereby increasing the costs of tax compliance of large enterprises.

Finally, Tax Practitioner 5, although agreeing that the existence of CFC and cross-border transactions drive the costs of tax compliance, replied by saying that:

... not necessarily from the perspectives of New Zealand taxation. Very often it can be tax laws of the other jurisdiction.

This implies that dealing with taxes of the jurisdiction where a CFC is located may increase cost of tax compliance for large enterprises from having a CFC or engaging in foreign operations.

The four factors, mentioned by the tax practitioners, contributing to the cost of tax compliance in large enterprises in New Zealand, along with their comments on them, suggest that certain characteristics of large enterprises may contribute to higher compliance costs. For example, complexity as a factor in determining the costs of tax compliance is more likely to be caused by complex business transactions or business restructuring undertaken by large enterprises, as well as simply by the size of a large enterprise. The other two factors – ongoing IR audits or disputes – are more likely to be triggered by the tax position taken by a large enterprise, with which the IR may disagree. This disagreement is most likely to be caused by a complex tax situation resulting from either a complex business transaction or uncertainty in the interpretation of tax legislation. Finally, frequently changing tax legislation, (which was perceived by Tax Practitioner 5 as the factor driving the costs of tax compliance), may be to a large extent the result of the new BEPS initiatives which are primarily focused on large multinational enterprises.

Engagement in business operations in foreign jurisdictions through a CFC or engagement in cross-border transactions also adds to costs of tax compliance of large enterprises based on the responses provided by the tax practitioners. An increase in the costs of tax compliance may occur due to the level of the complexity of foreign operations of a large enterprise, which can be expressed, for example, by the number of CFCs. The complex tax rules of CFCs, and of other cross border regimes contained in the ITA 2007, contributes to the increase in the costs of tax compliance. Although it is not possible to quantify the effect of each of the factors in this study, the previous literature can confirm the effect of the complexity of foreign operations

and the complex tax rules of CFCs on the costs of tax compliance. Blumenthal and Slemrod identify a number of characteristics relating to the complexity of foreign operations, including the value of foreign assets, number of foreign staff, foreign sales turnover and the number of majority owned foreign subsidiaries.<sup>18</sup> Statistical analysis undertaken by the authors showed that only the number of majority owned foreign subsidiaries had an effect on costs of tax compliance of the largest US corporations. This implies that having more CFCs contributes to increased costs of tax compliance. The authors further investigated the effect of features of the US Internal Revenue Code on the tax compliance costs of US large enterprises and found that a large number of respondents mentioned disclosure of information about CFCs and transfer pricing as the most complex areas of the US tax code in relation to foreign income.

### *6.3.3 Large Enterprises vs SMEs: Tax Compliance Activities and Composition of Tax Compliance Costs*

Based on the responses provided by the tax practitioners, this section provides some insights into the differences between SMEs and large enterprises in New Zealand in terms of how the tax compliance functions are carried out and the composition of tax compliance costs in these respective types of enterprises. The importance of looking into the differences in aspects of the tax compliance activities between SMEs and large enterprises lies in a fact that the tax compliance activities of SMEs in New Zealand have previously been studied and the costs measured.<sup>19</sup> However, little is known about how large enterprises carry out their tax compliance functions and the composition of their tax compliance costs. Moreover, gaining an insight into how the tax compliance activities of an organisation change when an organisation is growing will help to better understand the determinants and composition of tax compliance costs in large enterprises.

This subsection consists of two subparts: the first subpart discusses differences between SMEs and large enterprises with respect to how tax compliance functions are carried out; the second subpart explores whether the composition of tax compliance costs in large enterprises is different from the composition of tax compliance costs in SMEs.

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<sup>18</sup> Blumenthal and Slemrod, above n 17.

<sup>19</sup> See Chapter 2, section 2.3 of this thesis, for a brief outline of the studies of the cost of tax compliance in SMEs.

### 6.3.3.1 Tax Compliance Functions: Large Enterprises vs SMEs

Since the preparation of tax returns (at least the income tax return) should be a common feature of both SMEs' and large enterprises' tax compliance functions, the tax practitioners were asked the following question in order to gain their views on the difference between SMEs and large enterprises in regard to how their tax compliance is organised:

*“In your experience, what is the main difference (if there is any) between preparation of tax return for SMEs and large enterprises?”*

The tax practitioners' responses are provided in Table 6.7 below:

**Table 6.7: Difference between SMEs and large enterprises in the preparation of tax returns**

<p><b>Tax</b></p> <p><i>Practitioner 1</i></p>	<p>“I think in some ways the preparation of tax return can be easier for large enterprises if they spend some money on technology to help the problem, to set up automated processes to help them have good systems and people in place. While for SME the process is more manual and relatively more time consuming “</p> <p><b>Question:</b>  <i>So basically even if transactions of large enterprises are more complex transactions, still as you said, they may use technology and technology will help them to process it faster without spending too much time</i></p> <p>“Potentially. Large organisation may typically have complex transactions and set up in-house accounting of these transactions. Once you set up systems for processing it becomes pretty efficient to run. While for SME they may have complex transactions every now and then, after which they have to manually process it all...”</p> <p><b>Question:</b> <i>it is because they don't have money to set up such systems?</i>  <b>Answer:</b> “they won't spend money on the technology and processing and will pay us to help.          So if you measure cost of tax compliance based on the total amount of, say tax paid, large organisations will have a lower percentage than SMEs”</p> <p><b>Question:</b> <i>Why?</i>  <b>Answer:</b> “Because of [economies of] scale”</p> <p><b>Question:</b> <i>Right, because of economies of scale...</i></p> <p><b>Answer:</b> “Because large enterprises are particularly different type of businesses ... large corporates tend to have a wider range or higher frequency of transactions and because of that they may be forced to use technologies. While SMEs may have one or two tax adjustments, large organisation will have many more...”.</p>
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<b><i>Tax Practitioner 2</i></b>	<p>“The main difference probably will be the calibre and experience of the person who has done initial preparation of the tax material. It goes back to discussion where small and medium enterprises often may have this work done by the outside firm rather than themselves. They may have a person who has some accounting training to make initial preparations. While large businesses, may have up to 10-12 people working internally in accounting team. Those people are more likely to have knowledge and experience that will result in correct calculations being done internally and so external support will be mainly to review their tax return and provide some advice. While for small entities we probably will be doing calculations. Many small entities won’t be doing any calculations at all and for this we will have to compile all their accounting records or whatever their system is and prepare tax return from a scratch”.</p>
<b><i>Tax Practitioner 3</i></b>	<p>“There is complexity of a large enterprise’s operations vs that of SME. Therefore there is much higher risk of mistake. Unlike SMEs large enterprises compliance involves dealing with more regimes:</p> <ul style="list-style-type: none"> <li>- CFC</li> <li>- FIF</li> <li>- Financial Arrangement</li> <li>- Transfer Pricing</li> </ul> <p>Sometimes it may be necessary for a large enterprises to meet with the IR tax manager to review the tax return”.</p>
<b><i>Tax Practitioner 4</i></b>	<p>“Level of tax compliance. Large enterprises are more likely to have more complex transactions, like financial arrangements. While for SMEs transactions between owners-shareholders and company are more typical”.</p>
<b><i>Tax Practitioner 5</i></b>	<p>“SMEs are more likely to outsource everything to professional tax firms. Whereas large enterprises prepare tax returns internally using their own resources and after that ask professional tax advisors to review the return. Many more complex transactions, greater risk of mistakes”.</p>

From the responses provided, the following conclusions can be drawn about the difference in how tax compliance functions are undertaken by SMEs and large enterprises. The main difference is that, unlike the majority of SMEs, large enterprises have the resources for processing and preparing tax returns internally. Responses by Tax Practitioners 1, 2 and 5 confirm that the bulk of tax compliance work such as processing financial information and preparing the tax return, is usually carried out internally by large enterprises. The response provided by Tax Practitioner 1 was the most illustrative of how and why large enterprises process tax returns internally:

... they (large enterprise) spend some money on technology to help the problem, to set up automated processes to help them have good systems and people in place.

And:

... large organisation may typically have complex transactions and set up in-house accounting of these transactions. Once you set up systems for processing it becomes pretty efficient to run.

Therefore, large enterprises generally set up automated systems within their organisations and hire qualified staff to run these systems to prepare tax returns. Quoting the response from Tax Practitioner 2:

Large businesses, may have up to 10-12 people working internally in accounting team. Those people are more likely to have knowledge and experience that will result in correct calculations being done internally.

Unlike large enterprises, SMEs do not have the resources to do tax returns internally and therefore are more likely to outsource their tax compliance functions to external firms. According to Tax Practitioner 2:

...for small entities we probably will be doing calculations. Many small entities won't be doing any calculations at all and for this we will have to compile all their accounting records or whatever their system is and prepare tax return from a scratch.

Tax Practitioner 3 stated:

... SMEs are more likely to outsource everything to professional tax firm.

The much greater scale and complexity of operations carried out by large enterprises explains why they are more likely to set up automated systems and process tax records in-house. As Tax Practitioner 1 explained further:

Large enterprises are particularly different type of businesses ... large corporates tend to have a wider range or higher frequency of transactions and because of that they may be forced to use technologies. While SMEs may have one or two tax adjustments, large organisation will have many more.

Therefore, by setting up automated systems in-house in the first instance, large enterprises can reduce their costs of tax compliance due to economies of scale. This was confirmed in the response from Tax Practitioner 1:



... So if you measure cost of tax compliance based on the total amount of, say tax paid, large organisations will have a lower percentage than SMEs ... Because of [economies of] scale.

Furthermore, as large enterprises generally have more complex transactions, such as CFCs, FIFs, financial arrangements, transfer pricing (as mentioned by Tax Practitioner 3), they require more tax review and advisory services since the risk of mistakes is higher due to the complexity of transactions. Quoting tax practitioner 5:

...Many more complex transactions, greater risk of mistakes.

On the other hand, SMEs typically have more transactions with their owners (according to Tax Practitioner 4), and therefore, the level of complexity is lower.

As large enterprises have greater internal resources and carry out large scale operations, undertaking most of the work relating to calculations and preparation of tax returns internally seems to be a rational way for large enterprises to organise their tax compliance functions. However, the complexity of transactions and therefore heightened risk of mistakes require external tax practitioners to review the tax returns and provide advice regarding the tax positions taken in the return. On the contrary, according to tax practitioners interviewed, SMEs are more likely to outsource tax return preparation to external tax practitioners. This constitutes the main difference between large enterprises and SMEs in New Zealand concerning the organisation of their tax compliance activities.

The IR's "Better for customers: SMEs' compliance costs in 2016" report indicates that the median annual external cost of New Zealand SMEs was approximately 63% of their median annual in-house cost of tax compliance,<sup>20</sup> implying that SMEs do not outsource all of their tax compliance activities to external professionals. However, the report indicates that the majority of SMEs undertake the preparation of GST and PAYE returns in-house, while the preparation of income tax return is outsourced to external tax practitioners.<sup>21</sup> Thus, the findings from the IR's report appear to confirm the responses from the tax practitioners in relation to New Zealand SMEs being more likely to outsource the preparation of their income tax returns. Moreover, findings from the literature (outlined in Chapter 2, subsection 2.5.1 of this thesis)

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<sup>20</sup> IR "Better for customers: SMEs' compliance costs in 2016" (Full report, November 2016) at 8.

<sup>21</sup> IR, above n 20, at 14.

provide evidence that large enterprises are more efficient than SMEs in record keeping and tax computational activities. Therefore, large enterprises generally undertake these functions in-house. This again validates the feedback provided by the tax practitioners on how tax compliance activities are carried out by large enterprises in New Zealand.

Furthermore, in the case of large enterprises the pattern of separation of tax compliance activities between internal staff and external tax practitioners appears to be in line with the study by Eichfelder and Schorn<sup>22</sup> (outlined in Chapter 5, subsection 5.3.3 of this thesis). Eichfelder and Schorn,<sup>23</sup> using the profit optimisation model, found the strategy for the most cost-efficient tax compliance administration: undertaking part of tax compliance activities in-house (usually basic tax compliance activities such as record keeping, tax computation and lodgement of tax returns) and outsourcing more complex activities to external tax practitioners. The fact that large enterprises in New Zealand generally separate their tax compliance activities in this way suggests that New Zealand large enterprises are likely to be cost efficient in dealing with their tax compliance obligations.

#### *6.3.3.2 Composition of Tax Compliance Costs: Large Enterprises vs SMEs*

It has been noted in the studies conducted by Evans, Lignier and Tran-Nam<sup>24</sup> and Slemrod and Verkatesh,<sup>25</sup> that in contrast to SMEs, large enterprises have a greater propensity to rely more heavily on lawyers and tax advisers for external services. Moreover, expenditures of large enterprises on external legal services in relation to audit, litigation and tax appeals, and services on tax planning and tax advice are quite substantial. Evans, Lignier and Tran-Nam<sup>26</sup> estimated that almost 23% of the external cost of tax compliance of large enterprises in Australia related to audit and litigation, while expenditures on professional advice relating to tax planning was 24.4%. Slemrod and Blumenthal found that expenditures of the largest corporations in the US on external services relating to audit, appeals and litigation were almost 22% of the total

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<sup>22</sup> Sebastian Eichfelder and Michael Schorn “Tax Compliance Costs: A Business Administration Perspective” (2012) 68 *FinanzArchiv: Public Finance Analysis* 191.

<sup>23</sup> Eichfelder and Schorn, above n 22.

<sup>24</sup> Evans, Lignier and Tran-Nam, above n 6, at 776.

<sup>25</sup> Joel Slemrod and Varsha Venkatesh “The Income Tax Compliance Cost of Large and Mid-Size Businesses” (Ross School of Business Working Paper No. 914, University of Michigan, 2002) at 23.

<sup>26</sup> Evans, Lignier and Tran-Nam, above n 6, at 779.

external costs of tax compliance, while expenditures on tax planning accounted for 12% of the total external costs.<sup>27</sup> Susila and Pope estimated that large enterprises in Indonesia spent 48% of their total expenditures on services by external tax practitioners on audit, litigation and tax appeals.<sup>28</sup>

The fact that legal and tax planning services make up a substantial part of large enterprises total external costs of tax compliance suggests that the composition of tax compliance costs, at least the external costs in large enterprises, is different from the composition of tax compliance costs in SMEs. As mentioned above, in general large enterprises are likely to require more external services from lawyers and tax advisers, rather than accounting services as in the case of SMEs. In order to test the validity of this assumption for large enterprises in New Zealand, tax practitioners were first asked if, in their opinion or experience, large enterprises were more frequently involved in disputes with the IR and, second, whether large enterprises required more tax planning/tax advice services compared to SMEs.

The responses provided by the tax practitioners to the first question are presented in Table 6.8 below:

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<sup>27</sup> Slemrod and Blumenthal, above n 5, at 423.

<sup>28</sup> Budi Susila and Jeff Pope “The Tax Compliance Costs of Large Corporate Taxpayer in Indonesia” (2012) 27 Australian Tax Forum 719 at 730.

**Table 6.8: Are large enterprises more frequently involved in disputes with the IR?**

<b>Tax</b> <i>Practitioner 1</i>	<p>“I think it come back to earlier we were talking about how the IR assesses the risk. And the IR actually establishes relationship with large taxpayers, which means the IR is keeping on the top of taxes that coming out of these large taxpayers and ask account-managers to advise them if there going to be any changes in provisional tax payments or any significant decrease in the amount of tax payment. If you are a large taxpayer the government expect you to have a turnover of 20 million dollars, so if your large organisation doesn’t come up with this turnover .. ”.</p>
<b>Tax</b> <i>Practitioner 2</i>	<p>“I don’t think so, I mean I don’t think it is more than the other. In some way it may be potentially so, because of the information request that the IR requires from large enterprises ...they have to file annual questionnaire ...that is actually interesting because from my experience of being a tax adviser for 25 years the number of audits initiated by the IR that I have seen is actually quite small...in respect to clients I have been looking after ....”</p> <p><b>Question:</b> <i>Do you mean small or large enterprises?</i></p> <p><b>Answer:</b> In all.</p> <p><b>Question:</b> <i>But perhaps right now with new BEPS initiatives the IR might try to chase large enterprises more actively especially multinationals...</i></p> <p><b>Answer:</b> “Yes exactly, but it won’t be based on size, it will be based on the multinational exposure that probably won’t be differentiated...”.</p>
<b>Tax</b> <i>Practitioner 3</i>	<p>“Yes they do. Tax manager (within the IR large enterprises unit) may have relationship/interactions with a large enterprise’s tax account manager”.</p>
<b>Tax</b> <i>Practitioner 4</i>	<p>“They may and may not, from my experience the area where large enterprises might potentially get involved in a dispute with the IR is transfer pricing and tax positions that large enterprises chose in regard to particular transaction”.</p>
<b>Tax</b> <i>Practitioner 5</i>	<p>“60 organisations have tax account managers to deal with the IR. Often the IR may issue binding ruling. Many large enterprises have to submit compliance package. Overall large enterprises are involved in disputes more often than SMEs”.</p>

The responses given by all five tax practitioners interviewed suggest that large enterprises are potentially more likely to get involved in disputes with, or be audited by, the IR. However, as the experience of Tax Practitioners 1, 2 and 4 illustrates, in practice not so many large enterprises in New Zealand have disputes with, or are audited by, the IR. IR tax managers and large enterprises’ tax account managers have frequent interactions to ensure that large enterprises pay their taxes. Furthermore, those large enterprises included in the category of “significant enterprises” must submit a BCP every year.<sup>29</sup> Moreover, the IR can issue binding

<sup>29</sup> IR “Multinational Enterprises – compliance focus” (2016) at 4.

rulings in respect of particular transactions.<sup>30</sup> Perhaps these measures help to reduce the number of potential disputes between large enterprises and the IR. Nevertheless, Tax Practitioners 3 and 5 agreed that, overall, large enterprises are involved in disputes with the IR more often than SMEs:

Yes they do. Tax manager (within the IR large enterprises unit) may have relationship/interactions with a large enterprise's tax account manager.

They may and may not, from my experience the area where large enterprises might potentially get involved in a dispute with the IR is transfer pricing and tax policies that large enterprises chose in regard to particular transaction.

According to Tax Practitioner 4, potential areas where disagreement between the IR and large enterprises might arise are transfer pricing and tax positions chosen by large enterprise in regard to particular transactions.

Overall, on the basis of the responses provided by the tax practitioners in Table 6.8, it is difficult to say if large enterprises are involved in disputes with the IR more often than SMEs. In this regard, conducting interviews with tax managers and CFOs of large enterprises as well as undertaking a survey amongst large enterprises in New Zealand may shed more light on the number of ongoing disputes and litigations that large enterprises have with the IR. Moreover, undertaking a survey may allow the amount of expenditures incurred by large enterprises on external legal services in relation to these disputes and litigations to be quantified.

Table 6.9 below presents the tax practitioners' responses to the second question: whether large enterprises require more tax planning services than SMEs.

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<sup>30</sup> Tax Administration Act 1994, ss 91D and 91E.

**Table 6.9: Do large enterprises require more tax planning/ tax advisory services?**

<p><b>Tax</b></p> <p><i>Practitioner 1</i></p>	<p>“So what triggers the need for tax advice, if you do more transactions or unusual complex transactions, which is probably more likely to happen with large enterprises, so that why they call us for tax advice</p> <p><b>Question:</b> <i>So in your experience SMEs in New Zealand ...their business is focused on domestic operations and not so many SMEs doing cross-border transactions</i></p> <p><b>Answer:</b> “There are some, it depends on what sort of the sector you are looking at for example start-ups, technologies. They often do it quickly to access markets and obtain capital. Some are trying to raise capital in US, because people there may invest better in a new business than in New Zealand. So it depends on the sector, but if you are really generalising most of large enterprises are more likely to have off shore operations and therefore they need more international tax planning “.</p>
<p><b>Tax</b></p> <p><i>Practitioner 2</i></p>	<p>“I think it is not necessarily so. As there are small entities doing business on particularly complex base and so you may have this family owned business with turnover 2-3 million dollars and they are exploring perhaps going to Australian market and they would need advice on structuring it. The same principle applies to large organisations, where large organisations will have more opportunities for tax planning, more risks and more exposure to the overseas business transactions, they are more likely to have employees going offshore or they may be seconding employees from overseas to this area and they might require advice around them. In respect to the size, yes, large organisation is more likely to need more advice, but at the same time small organisation may still need an advice and unlike large organisation where you can get advice from CFO or accounting employee who understands tax concepts and tax rules, small organisations usually seek advice from external adviser”.</p>
<p><b>Tax</b></p> <p><i>Practitioner 3</i></p>	<p>“Yes. Main reason is complexity of large enterprises’ operations”</p>
<p><b>Tax</b></p> <p><i>Practitioner 4</i></p>	<p>“Large enterprises do require more tax planning and advisory services as they very often have cross-border transactions, more complex structure. This leads to transfer-pricing issues, which is itself a very complicated thing”.</p>
<p><b>Tax</b></p> <p><i>Practitioner 5</i></p>	<p>Large enterprises is more likely to require tax planning/tax advice. This is often related to buying businesses, investing offshore, having cross-border transactions. Or concluding large contracts. So large enterprises might need us to review the contract and find possible issues that might trigger tax (like grey areas of taxation, regarding deductibility)”.</p>

Based on the responses provided above it is possible to conclude that large enterprises indeed require more tax planning and advisory services than SMEs. All five tax practitioners agreed that it is so. Although Tax Practitioner 2, speaking from their professional experience, pointed out that SMEs may also require tax advisory services in respect of complicated tax situations. However, taking into account the factors of size, the complexity of transactions which may trigger various tax regimes such as transfer-pricing and thin capitalisation, and the desire of

large enterprises to choose tax minimising business structure, it would appear that large enterprises in comparison to SMEs will in general rely more on external tax planning and tax advisory services. Moreover, Eichfelder and Vaillancourt<sup>31</sup> argue that the larger the size of an enterprise, the more likely the enterprise is to resort to tax planning services.

While the tax practitioners' responses to the question on the frequency of disputes and litigation with the IR provided mixed results, their responses to the question whether large enterprises require more tax planning services seem to confirm that this is the case. This may be an indication that large enterprises in New Zealand have a different composition of the cost of tax compliance (at least the external costs) in which costs associated with services provided by legal and tax advisers make up substantially large share in the total costs. However, as mentioned earlier, further research using a survey may be helpful in establishing whether the composition of tax compliance cost of large enterprises in New Zealand does indeed differ from the composition in SMEs.

#### *6.3.4 Is Tax Planning Considered to be a Tax Compliance Activity?*

As noted by Evans, the costs of tax compliance can be divided into unavoidable costs of tax compliance (costs related to computations) and avoidable or voluntary costs (tax planning).<sup>32</sup> Many tax lawyers and policy-makers consider unavoidable costs as the only costs that should be included in computation of total costs of tax compliance.<sup>33</sup> However, in studies conducted by Evans, Lignier and Tran-Nam,<sup>34</sup> and Slemrod and Blumenthal,<sup>35</sup> the costs of tax planning, despite being considered as a voluntary cost of tax compliance, were nevertheless included in total costs of tax compliance of large enterprises.

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<sup>31</sup> Sebastian Eichfelder and Francois Vaillancourt "Tax Compliance Costs: A Review of Cost Burdens and Cost Structures" (Arqus Discussion Paper No. 178, 2014) at 23.

<sup>32</sup> Chris Evans "Taxation Compliance and Administrative Costs: An Overview" in Michael Lang and others (eds) *Tax Compliance Costs for Companies in an Enlarged European Community* (Kluwer Law International, The Netherlands, 2007), at 452.

<sup>33</sup> At 452.

<sup>34</sup> Evans, Lignier and Tran-Nam, above n 6.

<sup>35</sup> Slemrod and Blumenthal, above n 5.

Recognising the importance of the ongoing debate in the literature and amongst tax lawyers concerning the validity of including tax planning as a part of the tax compliance activities of large enterprises, the tax practitioners were asked for their opinions on this contentious aspect.

Their answers are provided below in Table 6.10:

**Table 6.10: Should tax planning be considered a part of tax compliance in large enterprises?**

<i><b>Tax</b> Practitioner 1</i>	<p>“Tax planning may be associated with a business requirements, like entering new markets or some other kind of unusual business transactions. So when we give advice we suggest that what is the best way to do it... so that planning is not in traditional sense is tax planning . So that sort of stuff and I think it is voluntary, the way I look at it is business as usual. So you have tax costs...tax compliance costs which are related to business as usual and are the cost of internal staff ... and external costs how much support you get from external advisers. Then there is a governance costs, in terms of how much costs the senior members of organisation, the board view their time...And then there are cost of technologies and planning certain transactions, which are voluntary. So the way I look at all these costs they are business as usual. There are also exceptional costs, like the cost of the IR investigation and they are also a part of compliance just a separate one. I would see tax planning as separate to compulsory compliance and I would see it as voluntary. I see it as a result of a new type of transaction or a new tax rule. You can’t just close your eyes to the tax implications of a transaction. This days it would be very rare to do some restructuring without underlying causes for this restructuring, like a change in the environment. So you may again say it was voluntary, but because there was a change in circumstances and environment, there was a change in organisation and a business ...”.</p>
<i><b>Tax</b> Practitioner 2</i>	<p>“Oh yes absolutely. I think planning is just “forewarned pre armed” thinking about the future organisation should plan ahead, especially when the IR has been successful in a number of cases on tax avoidance. In terms of planning, when you start talking about how to structure your business to minimise tax, people say: oh it is tax avoidance. So there is a lot of misconception about tax planning going around...”</p> <p><b>Question:</b> <i>Anyway it should be ...it should be considered a part of tax compliance</i></p> <p><b>Answer:</b> “Absolutely... even the simplest form of planning is thinking of what tax payments should be made in terms of minimising exposure to money interest ... as for large enterprises they should be thinking of what particular transactions might need to be taken care of in terms of taxes...”.</p>
<i><b>Tax</b> Practitioner 3</i>	<p>“Yes it does, very essential part of large enterprises activity. Helps to plan and foresee risks”.</p>
<i><b>Tax</b> Practitioner 4</i>	<p>“Yes tax planning is related to consideration of tax consequences of large enterprises’ activity like sale of assets, major transactions, cross-border transactions”.</p>
<i><b>Tax</b> Practitioner 5</i>	<p>“Yes it does, as I think it is inseparable part of large enterprises business transactions”.</p>



From the responses provided by the tax practitioners it appears that all five agreed that tax planning should be included in the overall tax compliance activities of large enterprises. However, the response from Tax Practitioner 1 was slightly ambiguous. From their response it may be concluded that, although tax planning is voluntary, it is nevertheless necessary when a large enterprise considers the tax implications of a new transaction or business restructuring. Thus, quoting Tax Practitioner 1:

... I would see it as voluntary. I see it as a result of a new type of transaction or a new tax rule. You can't just close your eyes to the tax implications of a transaction.

The tax implications of a new transaction or business restructuring are the main reasons why large enterprises resort to tax planning, and therefore, the cost of tax planning result from the necessity for large enterprise to consider these tax implications. The response provided by Tax Practitioner 4 indicated that tax planning:

[is] related to consideration of tax consequences of large enterprises' activity like sale of assets, major transactions, cross-border transactions.

Tax Practitioner 5 additionally stated:

[tax planning] is inseparable part of large enterprises' business transactions.

These responses confirm that the tax practitioners interviewed in this study, consider tax planning as a part of the overall tax compliance activity of large enterprises.

#### *6.4 Conclusion*

In this chapter the results of the interviews with five tax practitioners and an IR official were presented and analysed. As noted in the introduction to this chapter (see section 6.1), the purpose of the interviews conducted was to ascertain which enterprises are considered large in New Zealand, the magnitude and composition of the costs of tax compliance in large enterprises in New Zealand, the determinants of the costs of tax compliance in large enterprises, and how tax compliance in SMEs differs from tax compliance in large enterprises.

While it was expected that more accurate and informative responses would be provided by the tax practitioners interviewed, the responses received, nevertheless, provided sufficient information for the analysis and for conclusions to be drawn. The findings from the interviews

provided helpful insights into the area of the cost of tax compliance in large enterprises, albeit they signified that in order to obtain a fuller picture of the costs of tax compliance, a larger survey involving large enterprises is required. Conducting interviews with tax practitioners only is the main limitation of the study.

The main findings from the interviews and limitations of the interviews are elaborated on below. The first outcome from the interviews is that there is no universal understanding amongst tax practitioners concerning which enterprises are large in New Zealand. Each tax practitioner provided their own definition of a large enterprise, which was based either on their own concept of what criteria to use (turnover, number of employees or taxable profit), or on thresholds established by the FRA 2013 or the IR. As Tax Practitioner 2 remarked “it is in the eye of a beholder”, implying that the definition of a large enterprise depends to a great extent on who this question is asked to. The interview with the IR official helped to clarify the definitions the IR currently applies to classify large enterprises. In any future empirical studies of the cost of tax compliance of large enterprises in New Zealand, the definition of large enterprises (and accordingly the population of large enterprises) may need to be considered in the context of “significant enterprises”.

The second outcome of the interviews is that services in relation to income tax constitute the largest part of the services provided by external tax practitioners to large enterprises. According to the tax practitioners interviewed, this is the most time-consuming tax due to existence of various regimes associated with it. The complexity and extent of large enterprises’ business operations often trigger the application of these regimes, thereby increasing tax practitioners’ time on dealing with large enterprises’ income tax. A high percentage of expenses on income tax-related services out of total external expenses was also reported in studies by Slemrod and Blumenthal,<sup>36</sup> and Evans, Lignier and Tran-Nam,<sup>37</sup> for US and Australian large corporations. Although we cannot determine in this study the percentage of tax compliance costs that New Zealand large enterprises spend on their income tax-related external services, the responses from the tax practitioners suggest that it is possible that New Zealand large enterprises may have a composition of external costs of tax compliance that is comparable to US and Australian large enterprises.

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<sup>36</sup> Slemrod and Blumenthal, above n 5.

<sup>37</sup> Evans, Lignier and Tran-Nam, above n 6.

Due to the broad responses provided by the tax practitioners about the fee they charge large enterprises for various tax services, it was not possible to form a conclusion on the magnitude of the external cost of tax compliance in large enterprises in New Zealand. According to the responses from the tax practitioners, a large enterprise in New Zealand might be charged in the range of NZ\$ 2,000–NZ\$ 20,000 for a review of its tax return.

The third outcome of the interviews is that the main determinants of the costs of tax compliance in large enterprises, as identified by the tax practitioners, are complexity of transactions, IR audits and disputes, and frequently changing tax regulations. Based on the responses from the tax practitioners it is possible to conclude that size and the nature of business operations carried out by large enterprises contributes to an increase in the complexity of tax situations, thereby driving up the cost of external services. Often large enterprises initiate business restructuring, triggered by a changing economic environment, which in turn leads to a complex tax situation and increased cost of tax compliance. The existence of a CFC and engagement in cross-border operations are also factors which influence tax compliance costs. An increase in the costs here occurs due to the characteristics of the foreign operations of a large enterprise. These may, to a large extent, affect complexity, as well as complex tax rules related to CFC and cross-border regimes. Blumenthal and Slemrod <sup>38</sup> also found that the number of CFCs, and complex rules in the US Internal Revenue Code related to CFCs, were some of the main factors driving the costs of tax compliance in large US corporations.

The fourth outcome of the interviews is that, based on the tax practitioners' responses, SMEs and large enterprises in general organise their tax compliance functions in different ways. Large enterprises usually have internal resources and automated systems to process the information required for filing tax returns and making necessary calculations. External tax practitioners mainly review tax returns given that the risks of taking a wrong tax position are very high for large enterprises. By the way of contrast, SMEs are more likely to outsource tax preparation and filing functions to external tax practitioners as they do not have sufficiently qualified employees to perform these roles. The findings in the IR's 2016 report<sup>39</sup> on the costs

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<sup>38</sup> Blumenthal and Slemrod, above n 17.

<sup>39</sup> IR, above n 20.

of tax compliance in SMEs in New Zealand partly<sup>40</sup> confirm the tax practitioners' responses with respect to SMEs outsourcing the preparation of their tax return to external tax practitioners.

Another difference between SMEs and large enterprises pertains to the composition of external costs of tax compliance. Evans, Lignier and Tran-Nam<sup>41</sup> mention that large enterprises rely more heavily on the services of lawyers and tax advisers, rather than accounting services (as is the case with SMEs). The responses from the tax practitioners were not conclusive as to whether large enterprises get involved in legal disputes with the IR more often than SMEs and therefore require more legal services. However, their responses confirmed that in regard to tax planning services there is a possibility of the composition of the external costs of tax compliance of large enterprises in New Zealand being different from SMEs in that large enterprises require more tax planning services from external tax practitioners than SMEs.

Finally, all five tax practitioners agreed that tax planning should be considered as a part of the tax compliance activities of large enterprises. Considering that large enterprises are more efficient than SMEs in dealing with record keeping, calculations and preparation of tax returns, it is reasonable to assume that basic tax compliance is of less relevance to large enterprises. Consequently, it is also reasonable to assume that large enterprises have a better control than SMEs over their internal cost of tax compliance. The contribution of external costs to the total tax compliance costs of large enterprises should be quite significant since large enterprises frequently engage in complex transactions and require more tax planning services. In this regard, it is also possible to assume that external costs of tax compliance are of a greater relevance to large enterprises (than internal costs).

Although the interviews have provided useful insights about various aspects of the costs of tax compliance in large enterprises, it is still not possible to make inferences about the magnitude and composition of tax compliance costs of large enterprises based on the responses received from the five tax practitioners. In addition, little inference can be made about differences in the tax compliance function and the composition of the costs of tax compliance between SMEs and large enterprises from this study. Overall, further investigation is required in order to ascertain the magnitude, composition and factors driving the costs of tax compliance in large enterprises. As suggested earlier in this chapter, interviews with tax managers and CFOs of

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<sup>40</sup> These findings confirm the tax practitioners' responses partly because SMEs are more likely to outsource the preparation of their income tax returns while retaining preparation of GST and PAYE returns in-house.

<sup>41</sup> Evans, Lignier and Tran-Nam, above n 6, at 776.

large enterprises could assist in ascertaining whether internal costs of tax compliance are of less relevance to large enterprises and gaining a fuller picture of the composition of the tax compliance costs of large enterprises. Furthermore, an empirical study would be helpful in estimating the magnitude and percentage breakdown of the costs of tax compliance. Data for such an empirical study could be collected through a large-scale survey conducted amongst large enterprises in New Zealand. This would require establishing criteria to define a large enterprise so that a representative sample can be drawn from the population of large enterprises in New Zealand. These are the tasks for future research.

## **Chapter 7: Conclusion**

### *7.1 Introduction*

This chapter provides an overview of the study along with a summary of the research findings. In addition, this chapter outlines the limitations, policy implications and areas for future research as well as sets out concluding comments. Accordingly, the structure of the remainder of the chapter is as follows. Section 7.2 presents an overview of the thesis, followed by section 7.3 which provides a summary of the major findings from this research. Section 7.4 outlines the contribution made by this research, while section 7.5 sets out main limitations of the research. The policy implications and recommendations for future research are provided in section 7.6. Finally, Section 7.7 presents the concluding remarks.

### *7.2 Thesis Overview*

The costs of tax compliance are considered in the literature as an extra burden on taxpayers. Due to the regressive nature of the cost of tax compliance the focus of the academic literature has been predominately on Small and Medium Enterprises (SMEs). While the role that large enterprises play in national and global economies is significant,<sup>1</sup> very few studies have been conducted to date on the costs of tax compliance of large enterprises. Available studies include empirical works focused on large enterprises in countries such as the United States (US), Canada, Australia, Indonesia and Hong Kong.<sup>2</sup> Notwithstanding these studies little is known about the magnitude, composition and factors affecting the costs of tax compliance of large enterprises in New Zealand. In addition, there is no common definition of a large enterprise in

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<sup>1</sup> George Serafeim “The Role of the Corporation in Society: An Alternative View and Opportunities for Future Research” (Harvard Business School Working Paper No. 14-110, 2014).

<sup>2</sup> See John Slemrod and Marsha Blumenthal “The Income Tax Compliance Cost of Big Business” (1996) 24 Public Finance Quarterly 411; Brian Erard “The Income Tax Compliance Burden on Canadian Big Business” (Working Paper 97-2 prepared for the Technical Committee on Business Taxation, 1997); Chris Evans, Philip Lignier and Binh Tran-Nam “Tax Compliance Costs of Large corporations: An Empirical Inquiry and Comparative Analysis” (2016) 64 Canadian Tax Journal 751; Budi Susila and Jeff Pope “The Tax Compliance Costs of Large Corporate Taxpayer in Indonesia” (2012) 27 Australian Tax Forum 719; Samuel Chan and others “Compliance Costs of Corporate Taxation in Hong Kong” (1999) 25 International Tax Journal 42.

the literature and consequently, the concept of large enterprises still remains unclear. Therefore, the purpose of this study has been to provide an explorative analysis of the costs of tax compliance of large enterprises in New Zealand and to examine the various criteria which can be used in order to establish a common definition of a large enterprise in New Zealand.

Accordingly, a qualitative analysis using six semi-structured interviews with tax practitioners and an Inland Revenue (IR) official in New Zealand have been undertaken in order to ascertain the magnitude, composition and drivers of the tax compliance costs of large enterprises in New Zealand. In addition, the opinions of the tax practitioners as well as the IR's position on which entities are considered large in New Zealand was sought in these interviews. The interview findings enabled inferences to be made regarding the composition and factors driving the costs of tax compliance of large enterprises in New Zealand. Furthermore, the interview findings provided insights into developing a common definition of large enterprises in New Zealand.

### *7.3 Summary of Findings*

This section presents a summary of the main findings on the research questions, as set out in Chapter 1, section 1.3 of this thesis.

#### *7.3.1 Research Question 1*

*RQ1: How can we define a "large enterprise" in New Zealand, if we want to study and measure its tax compliance costs?*

Prior to conducting the interviews, the analysis outlined in Chapter 3 of this thesis was undertaken in order to clarify how large enterprises, particularly in New Zealand, can be defined and explore whether it was possible to arrive at a common definition for New Zealand. The analysis indicated that generally the size of an enterprise can be determined using two types of criteria: quantitative and qualitative. Quantitative criteria are more convenient as they operate with values such as turnover, number of employees or value of assets, and are easy to understand, identify and measure. Therefore, quantitative criteria have been predominately used in prior studies measuring the costs of tax compliance of large enterprises. Various quantitative criteria have been established by different stakeholders. In New Zealand these stakeholders include the Inland Revenue (IR), the Ministry of Business, Employment and

Economic Development (MBIE) and the Financial Reporting Act 2013 (FRA 2013). The differing numerical thresholds used to define large enterprises by these stakeholders creates uncertainty as to what criteria and threshold to choose. The size of the population of large enterprises in New Zealand will accordingly depend on this choice.

In comparison, qualitative criteria reflect the intrinsic features of a large enterprise, which not only pertain to an enterprise of a larger size, but also signify that the enterprise is not an SME. Three qualitative criteria: organisational structure, capital structure and geographical span of business operations, were considered in Chapter 3. Although a strong correlation between the size of an enterprise and all three characteristics has been established in the literature, applying qualitative criteria alone may not always be helpful in separating large enterprises from SMEs. In this regard, as indicated by the analysis, a combination of quantitative criteria, for example, turnover, and one or more of the three of the qualitative criteria, could help to establish the lowest threshold above which certain enterprises in New Zealand would be considered to be large.

The responses provided by the tax practitioners revealed that there was no universal understanding amongst them concerning which enterprises in New Zealand are considered to be large. As one of the tax practitioners interviewed remarked, the definition of a large enterprise largely depends on who is answering the question. Although, in general, the tax practitioners interviewed preferred to rely on quantitative criteria to define a large enterprise, one of the tax practitioners defined large enterprises in terms of a qualitative criterion.<sup>3</sup> This shows that the application of both quantitative and qualitative criteria is possible for arriving at the definition of a large enterprise in New Zealand.

The interview with the IR official provided useful insights into the relevant criteria and thresholds which the IR currently applies to classify large enterprises. The finding from the interview revealed that the IR no longer officially applies the term “large enterprise” for tax compliance purposes. Rather it uses the definition of a “significant enterprise” for monitoring the tax compliance of this class of enterprises. Significant enterprises, which are included in the upper threshold (NZ\$80 million annual Goods and Services Tax (GST) turnover) were referred to by the IR official during the interview as “large enterprises”, despite the absence of

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<sup>3</sup> The qualitative criterion was having a tax manager in an organisation. See chapter 6, subsection 6.3.1.1, Table 6.2 of this thesis.



such concept. This suggests that the current criteria and threshold, which apply to significant enterprises, may serve as a basis for the future empirical studies of the costs of tax compliance of large enterprises in New Zealand.

In summary, the explorative analysis, and the feedback from the tax practitioners and the IR official, showed that in order to determine which enterprises are considered large in New Zealand for measuring the costs of tax compliance, the use of both quantitative criteria<sup>4</sup> (with thresholds provided by the IR),<sup>5</sup> and qualitative criteria, can assist in defining a population of large enterprises in New Zealand.

### 7.3.2 Research Question 2

*RQ2: What are the magnitude, composition and drivers of tax compliance costs in large enterprises in New Zealand?*

The broad responses provided by the tax practitioners interviewed in relation to the fee that their firms would charge large enterprises for the tax related services prevented a conclusion to be formed about the magnitude of the external costs of tax compliance of large enterprises in New Zealand. Moreover, the fee indication provided by the tax practitioners mainly related to a review of internally prepared tax returns, and as such could be in the range of NZ\$2,000–NZ\$20,000, depending on complexity. One of the participants replied that the fee charged to a large enterprise for tax-related services could be as high as NZ\$750 (and possibly above) per hour. While the magnitude of the costs of tax compliance borne by large enterprises in New Zealand cannot be estimated based on the interview responses alone, the range of provided fees may at least suggest that the external costs of tax compliance of large enterprises could be sizable.

As in the case with the magnitude of the costs of tax compliance, it was difficult to determine the composition of the costs of tax compliance in large enterprises based on the interviews conducted with the external tax practitioners alone. The interview results indicated that the services provided by the external tax practitioners to large enterprises include the review or

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<sup>4</sup> Business turnover can be the most helpful criterion for comparing the size of enterprises. See Tom Gibson and HJ van der Vaart “Defining SMEs: a less Imperfect Way of Defining Small and Medium Enterprises in Developing Countries” (Brookings Global Economy and Development, 2008) at 14.

<sup>5</sup> Thresholds used to classify “significant enterprise”. See Chapter 6, subsection 6.3.1.2 of this thesis.

preparation of tax returns, tax advisory, tax planning, installation of specialised tax software and responding to IR requests for information.

The main finding from this part of the interviews is that among the services provided by the tax practitioners, income tax related services are the most often required by large enterprises. Moreover, providing income tax services to large enterprises took up most of the tax practitioners' time when they provided services to large enterprises. Given the importance of income tax-related external services to large enterprises and that it was regarded by the tax practitioners as the most time-consuming type of tax service, it is reasonable to assume that expenses on external services related to income tax is the largest category of expenses that large enterprises in New Zealand spend on services provided by external tax practitioners. This finding is consistent with two previous studies conducted on large enterprises in the US<sup>6</sup> and Australia<sup>7</sup>. In both of these studies, expenses on income tax-related services were found to be the largest among total external tax compliance expenses. Although the external expenses of large enterprises in New Zealand cannot be quantified in this study, the responses provided by the tax practitioners in this regard suggest that it is possible that the composition of the external cost of tax compliance of large enterprises in New Zealand may be comparable to the composition of external costs of large enterprises in the US and Australia.

In regard to the drivers of the costs of tax compliance, the following conclusion can be made based on the interview findings. The first driver is the complexity of large enterprises' business operations which stems from the size and nature of operations, and also from the fact that large enterprises are more likely to undertake business restructuring. As one of the tax practitioners remarked, basic tax compliance activity is no longer a driving factor behind the costs of tax compliance for large enterprises, but rather it is the economic environment in which large enterprises operate. Complex economic transactions initiated by large enterprises in turn increase the complexity of advisory services provided by external tax practitioners, which ultimately impacts on the price of these services. The second and the third drivers identified by the tax practitioners interviewed are IR audits and penalties. These two drivers might be caused by either the tax position taken by large enterprises in a complex tax situation or by the uncertainty involved in the interpretation of tax legislation. The fourth driver is the frequently

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<sup>6</sup> Slemrod and Blumenthal, above n 2.

<sup>7</sup> Evans, Lignier and Tran-Nam, above n 2.

changing tax legislation. Specifically, the new Base Erosion and Profits Shifting (BEPS) initiatives which affect tax compliance of multinational enterprises (particularly large multinational enterprises) are one of the factors contributing to the costs of tax compliance in large enterprises. Many complex transactions, especially cross-border transactions, carried out by large enterprises trigger various tax regimes in New Zealand, such as thin capitalisation rules, transfer-pricing and permanent establishment (PE) rules (which are now more extensively covered by the new BEPS rules).<sup>8</sup> The tax practitioners' perceptions of frequently changing tax legislation being a driver of the costs of tax compliance in large enterprises in New Zealand is substantiated by findings in the literature. Frequently changing tax legislation was found to be one of the main factors contributing to tax complexity in multinational enterprises in a study conducted by Hoppe and others.<sup>9</sup> Moreover, the study also found that frequently changing tax legislation occurs mainly through the BEPS rules.<sup>10</sup>

The interview results further indicated that engaging in cross-border transactions through a controlled foreign company (CFC) also contributes to the costs of tax compliance of large enterprises. The responses received from the tax practitioners showed that the increase in the costs is primarily due to the following factors. The first factor is the complexity of the CFC rules, thin capitalisation and transfer pricing regimes, which require large enterprises to seek assistance of external professionals who have the knowledge and skills to deal with tax issues related to these regimes. It is worth noting that in addition to the complexity of the CFC and other regimes, the complexity of the foreign operations of a large enterprise, expressed by the number of CFCs that a large enterprise has in foreign jurisdictions, may also affect the costs of tax compliance. Empirical literature<sup>11</sup> confirms the positive effect of the number of CFCs on the costs of tax compliance of large enterprises in the US as well as the effect of complex CFC rules in the US Internal Revenue Code. The second factor is the desire of large enterprises to structure their business around CFCs to minimise their global tax, which again requires

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<sup>8</sup> IR "Taxation (Neutralising Base Erosion and Profit Shifting) Bill-Commentary on the Bill" (2017). Also, see subsection 4.3.1 of this thesis for discussion of recently adopted BEPS initiatives in New Zealand.

<sup>9</sup> Thomas Hoppe and others "What Are the Drivers of Tax Complexity for Multinational Corporations? Evidence from 108 Countries" (WU International Taxation Research Paper Series No. 2017-12, 2017).

<sup>10</sup> At 10.

<sup>11</sup> Marsha Blumenthal and Joel B Slemrod "The Compliance Cost of Taxing Foreign-Source Income: Its Magnitude, Determinants, and Policy Implications" (1995) 2 International Tax and Public Finance 37.

assistance of external tax practitioners. The third factor is the increased risk from involvement in CFC, thin capitalisation and transfer-pricing regimes, which requires tax returns to be reviewed by external tax practitioners. Finally, the existence of CFCs may drive up the costs of tax compliance due to the necessity to deal with the legislation in the foreign jurisdictions where the CFCs are located.

### *7.3.3 Research Question 3*

*RQ3: How do large enterprises differ from SMEs in terms of the tax compliance activities and composition of tax compliance costs?*

There are two main findings from the interviews with the tax practitioners in regard to research question 3. The first finding concerns the difference between SMEs and large enterprises in terms of how their tax compliance activities are carried out. The main difference is that, unlike SMEs, large enterprises have resources to process and prepare tax returns internally. Large enterprises have technology and automated systems in place and are able to hire qualified staff to run these systems. In contrast, SMEs do not have such resources and have to rely on the services of external tax practitioners. The fact that the majority of SMEs in New Zealand outsource the preparation of their income tax returns is confirmed by the IR's 2016 report on the costs of tax compliance of New Zealand SMEs.<sup>12</sup> As mentioned by one of the tax practitioners, large enterprises represent essentially a different type of business which is much larger in scale and features a large number of transactions. In this regard, technology and automated systems installed in-house allow large enterprises to efficiently process large volumes of financial information and thus, provide the benefit of economies of scale. Consequently, compared to SMEs, large enterprises are more likely to prepare tax returns internally rather than outsourcing this process. However, large enterprises are more likely to require from external tax practitioners, the reviewing of their internally-prepared tax returns and obtaining tax advice as the risk of error is higher due to complexity of their business operations.

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<sup>12</sup> IR "Better for customers: SMEs' compliance costs in 2016" (2016).

In general, by separating tax compliance activities between internal staff and external tax practitioners, large enterprises appear to follow a model of cost efficient tax compliance administration, according to which simpler tasks are performed in-house while more complex tasks are outsourced. The model of cost optimal tax compliance administration has been described in the literature.<sup>13</sup>

The second finding is related to the composition of the external costs of tax compliance of large enterprises and SMEs. Large enterprises are likely to have a different composition of external costs of tax compliance as they require more tax planning services from external tax practitioners than SMEs do. The literature indicates<sup>14</sup> that due to their large size, complex transactions and increased risks, large enterprises in general require more legal services from external advisers, whereas SMEs typically require more accounting services from external professionals. The validity of this assertion was tested during the interviews. The tax practitioners were asked if large enterprises were more frequently involved in legal disputes with the IR and whether they required tax planning services more often compared to SMEs. The tax practitioner responses to these questions brought mixed results. It was not possible to confirm that large enterprises in New Zealand get involved more often than SMEs in legal disputes. However, since the tax practitioners' responses indicated that large enterprises require tax planning services more often than SMEs, it is possible to draw a tentative conclusion that the composition of the external costs of tax compliance of large enterprises in New Zealand is likely to differ from SMEs.

Overall, the literature<sup>15</sup> and the interview findings<sup>16</sup> suggest that tax calculations and tax filing activities (that is, the basic tax compliance activities) are of less relevance to large enterprises due to their efficiency in dealing with these activities, and that the main costs drivers identified by the tax practitioners interviewed primarily affect external costs. Therefore, it is reasonable to assume that the external costs of tax compliance make a tangible contribution to the total

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<sup>13</sup> Sebastian Eichfelder and Michael Schorn "Tax Compliance Costs: A Business Administration Perspective" (2012) 68 *FinanzArchiv: Public Finance Analysis* 191.

<sup>14</sup> Evans, Lignier and Tran-Nam, above n 2, at 776.

<sup>15</sup> Sebastian Eichfelder and Francois Vaillancourt "Tax Compliance Costs: A Review of Cost Burdens and Cost Structures" (Arqus Discussion Paper No. 178, 2014) at 21.

<sup>16</sup> See chapter 6, subsection 6.3.3.1 of this thesis.

cost of tax compliance of large enterprises in New Zealand and thus, arguably are of greater relevance to large enterprises.

#### *7.4 Research Contribution*

This section will discuss three key contributions made by this study. These address the following aspects:

- definition of large enterprises
- cost of tax compliance of large enterprises
- tax administration in large enterprises and cost of tax compliance

##### *7.4.1 The Definition of Large Enterprises*

The first contribution of this study to the literature is that it provides insights into the definition of a large enterprise, and demonstrates how the use of qualitative criteria may assist in determining the population of large enterprises in New Zealand. By showing that existing thresholds and criteria are established by various stakeholders for different purposes and therefore are often not compatible with each other, this study emphasises the importance of using qualitative criteria along with quantitative criteria. To the researcher's knowledge, the analysis undertaken of which entities can be considered large in New Zealand is the first such study to define large enterprises using qualitative characteristics. This analysis is expected to assist in broadening the concept of a large enterprise (that is, the intrinsic features of large enterprises), which set them apart from SMEs. Therefore, in the New Zealand context, this analysis also points to the necessity of revisiting the definition of a SME since currently the line separating SMEs from large enterprises in New Zealand is blurred. Furthermore, the interview with the IR official provided further useful insights into the classification of "significant" enterprises applied by the IR. In the researcher's opinion the analysis and the insights gained from this interview can be used as a foundation for future multi-faceted research in areas related to large enterprises in New Zealand, including studies into the costs of tax compliance of large enterprises.

#### *7.4.2 Cost of Tax Compliance of Large Enterprises in New Zealand*

The second contribution this study has made is bridging the gap in the literature on the costs of tax compliance of large enterprises in New Zealand. To date no study has been conducted in this area in New Zealand and therefore the findings made in this study shed light on aspects such as the magnitude, composition and determinants of tax compliance costs of large enterprises in New Zealand. The findings made in regard to the determinants of the cost of tax compliance reinforce the findings from the prior studies showing that the complexity of the business activity of large enterprises and business restructuring initiated by large enterprises in response to economic factors, often appear to be the drivers of the costs of tax compliance. These findings are considered useful in the New Zealand context as they provide a valuable insight into the potential sources of the burden of tax compliance in large enterprises in New Zealand.

Furthermore, this study provides insights into the differences between large enterprises and SMEs in New Zealand in regard to the implementation of the tax compliance function and the composition of external costs of tax compliance. These insights are useful as they show how the tax compliance function and the composition of external costs of tax compliance change as the size of an enterprise increases.

The fact that most of the findings in this study (obtained through the semi-structured interviews with the five New Zealand tax practitioners) are compatible with the existing overseas empirical research increases the usefulness and validity of these findings. It is believed that the findings from the qualitative research conducted will both provide direction and become a good foundation for the future empirical studies into the area of the cost of tax compliance of large business in New Zealand.

#### *7.4.3 Tax Administration of Large Enterprises and the Costs of Tax Compliance*

The third contribution made by this study is to raise the issue of how the tax compliance administration in large enterprises affects the costs of the tax compliance. Tax compliance administration in large enterprises is an established system of organising and dealing with tax compliance functions. Generally, the tax compliance functions in large enterprises can be performed by internal staff and external tax practitioners. The optimal distribution of tax

compliance functions between internal staff and external professionals should ensure the most cost efficient tax compliance administration.

A mathematical model<sup>17</sup> of the profit maximising behaviour of a firm based on the premises of rational choice was discussed in this study. According to this model, the most optimal distribution of tax compliance functions that minimises the costs of tax compliance in large enterprises is when simpler tasks, like tax return preparation, are undertaken internally. The more complex tasks, like tax return review and tax advisory, are outsourced to external tax practitioners. The findings of this study (discussed in chapter 7, section 7.3.3 of this thesis) indicate that large enterprises in New Zealand appear to follow cost optimal tax compliance administration. According to the study's findings, large enterprises in New Zealand set up in-house automated systems which allow them to process multiple transactions efficiently and prepare tax returns internally. At the same time they outsource to external tax practitioners more complex functions, like tax returns review, which require a higher level of specialised knowledge.

The idea that the costs of tax compliance in large enterprises are also determined by the optimality of the tax compliance administration would be interesting area for future research into the measurement of the avoidable costs of tax compliance. According to Lignier, Evans and Tran-Nam,<sup>18</sup> costs that result from the choice a taxpayer makes as to how to organise their tax compliance activities belongs to the category of avoidable costs of tax compliance. However, these costs cannot be observed in practice.<sup>19</sup> Therefore, the model outlined in chapter 4 section 4.3.3 of this thesis might become a foundation for future research into the issue of unobservable costs of tax compliance in large enterprises.

### *7.5 Limitations of the Study*

The findings of this study, which were discussed above in sections 7.3.1, 7.3.2 and 7.3.3, should be interpreted in the light of the following limitations. The first limitation is that the interviews

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<sup>17</sup> Eichfelder and Schorn, above n 13.

<sup>18</sup> Philip Lignier, Chris Evans and Binh Tran-Nam "Measuring Tax Compliance Costs: Evidence from Australia" in Chris Evans, Richard Krever and Peter Mellor (eds) *Tax Simplification* (Kluwer Law International, The Netherlands, 2015) at 125.

<sup>19</sup> At 125.



were conducted with external tax practitioners only. Given that tax practitioners usually provide information from their perspective as external tax advisers of large enterprises, it is presumed that predominately external costs of tax compliance have been referred to and accordingly, analysed. Fuller information on the magnitude, composition and determinants of the costs of tax compliance in large enterprises, which would include internal costs of tax compliance, could be gathered through interviews with tax managers or Chief Financial Officers (CFOs) of large enterprises.

The second limitation concerns the limited time which the tax practitioners had available for the interviews. At the outset of the study it was expected that more questions would be asked during interviews. However, owing to time limitations, several questions were omitted from the interviews. Thus, questions asking for the tax practitioners' opinions on how the costs of tax compliance can be reduced in large enterprises and if large enterprises follow optimal tax compliance administration, were omitted. In addition the responses provided by some of the tax practitioners turned out to be vaguer than the researcher expected. Furthermore, in those interviews which were conducted by phone, the tax practitioners provided more limited responses. Generally the responses provided by phone were shorter and less clear compared to the more comprehensive responses provided by the tax practitioners in the face-to-face interviews.

The third limitation is the small number of tax practitioners interviewed in this study. Interviewing a larger number of participants (for example, 12-15) might have generated more data which could have provided more findings or have strengthened the validity of the findings obtained. However, as data saturation is believed to be reached after the fifth interview, and taking into account relatively small population of large enterprises in New Zealand,<sup>20</sup> it is unlikely that significantly new data would have been provided had more tax practitioners been interviewed.

The fourth limitation is that although the findings of this study provide preliminary insights into the magnitude, composition and determinants of the costs of tax compliance of large enterprises in New Zealand, these findings nevertheless cannot be generalised over the whole population of large enterprises in New Zealand. This is due to the small sample of the interview participants and qualitative nature of the data collected from the interviews.

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<sup>20</sup> See subsection 5.4.2.4 of this thesis for more details regarding the sample size.

## *7.6 Policy Implications and Recommendations for Future Research*

This section provides an overview of possible policy implications arising from this thesis and also sets out recommendations for future research.

The policy implications are anticipated to serve as a recommendation to the IR for:

- measuring the level of complexity of tax compliance obligations faced by large enterprises in New Zealand
- defining large enterprises
- reconsidering the stance taken by the IR on the issue of tax planning

The usefulness of these policy recommendations is that they outline potential areas of tax complexity and actions that the IR could undertake in order to eliminate, if not all, but at least unnecessary complexity. Moreover, they seek to draw attention of the tax authorities in regard to the importance of establishment of the definition of large enterprises in New Zealand.

Further, some recommendations are also provided in regard to methods of approaching tax practitioners and large enterprises for conducting interviews.

The recommendations for the future research set out potential directions in which further investigation of the cost of tax compliance of large enterprises could be undertaken.

### *7.6.1 Implications of Tax Complexity*

First, the findings made in this study indicate that the complexity of various tax regimes is one of the most important drivers of the cost of tax compliance of large enterprises in New Zealand. In particular, complex rules for CFCs, transfer pricing and thin capitalisation were referred to by the tax practitioners in subsection 6.3.2.3 of this thesis as the factors contributing to the increase in the external cost of tax compliance. The adoption of the new BEPS initiatives, explained in more detail in section 4.3.1, are likely to increase even further the cost of complying with new rules primarily due to the following reasons:

- the new BEPS rules strengthen previously existing rules, for example transfer pricing,<sup>21</sup> and increase the level of accountability, for example by requiring large multinational groups to submit Country-by country report (CbCR), which will increase their reliance on the services of external tax practitioners even further;<sup>22</sup>
- the new BEPS rules are likely to increase a number of instances of audits from the IR as contracts between related parties will be viewed with a greater suspicion from now on.<sup>23</sup> This will increase reliance on legal support from external advisers and lawyers;
- the new BEPS rules increase the level of complexity, for example by imposing legislative requirements to establish the credit rating of the New Zealand borrower in the case of borrowing from a cross-border related-party.<sup>24</sup> At the same time, the BEPS rules also raise the level of uncertainty. This implies that large enterprises are likely to resort even more to the assistance of external tax practitioners for the advice on tax implications that a particular BEPS rule might have for their business operations.

It is worthwhile noting that the extent of increase in the cost of tax compliance caused by the adoption of the BEPS rules will to a great degree depend upon whether large enterprises respond by taking a more aggressive stance (by engaging in more tax planning) or by taking a conservative approach.

Therefore, one possible measure that IR could take in order to mitigate to some extent the potentially negative impact of newly adopted BEPS rules on the cost of tax compliance of large enterprises is to organise a collection and analysis of the data on the cost of tax compliance of large enterprises. The data could be collected through a large scale survey distributed among large enterprises, which would aim to seek an information regarding the magnitude of internal and external cost of tax compliance. In addition, the survey should include questions, asking, for example, what tax rules (including BEPS rules) are seen by large enterprises as the most

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<sup>21</sup> See Adrian Sawyer and Richard McGill “The Adoption of BEPS in New Zealand” in Kerrie Sadiq, Adrian Sawyer and Bronwyn McCredie (eds) *Tax Design and Administration in a Post-BEPS Era: A Study of Key Reform Measures in 18 Jurisdictions* (Fiscal Publications, 2019) at 221.

<sup>22</sup> Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018, s 58; Tax Administration Act 1994 (TAA 1994), s 78G.

<sup>23</sup> The Mazars “BEPS – A New Paradigm or Just More Complexity?” ( 21 May 2015) <<https://mazarsledger.com/beps-a-new-paradigm-or-just-more-complexity/>> (last accessed 29 June 2019).

<sup>24</sup> See Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018, above, n 22, s GC16.

burdensome to comply with and the completion of what forms appears to be most difficult and causes confusion.

As the cost of tax compliance are viewed as a proxy for measurement of the complexity of tax rules,<sup>25</sup> it is anticipated that survey results will allow an estimate of the monetary effect of tax rules to be made, particularly the BEPS rules. The high cost to comply with a particular rule should warn tax authority that this rule requires simplification. As, Budak, James and Sawyer<sup>26</sup> point out, a “considerable degree of complexity is inevitable”,<sup>27</sup> given different objectives of taxation and, therefore, achieving tax simplification is not always possible. While complete elimination of complexity does not appear to be possible, it is a feasible task to eliminate unnecessary complexity. In this regard, the proposed methods of monitoring the cost of tax compliance and gaining feedback from large enterprises on areas of complexity, should assist the IR in reducing at least unnecessary complexity.

#### *7.6.2 Implications of Definitional Issues*

Second, as was set out in section 7.3.1, it is difficult to establish a common definition of large enterprises in New Zealand due to the existence of various criteria and thresholds. In this regard, it is advisable that IR makes it clear as to what enterprises can be considered to be large for the purpose of tax compliance. The definition of “significant enterprises”, which IR currently applies to monitor tax compliance of enterprises whose turnover or number of employees is above certain thresholds,<sup>28</sup> provides little insight into what category of enterprises within “significant” are actually large. Moreover, uncertainty with the definition of large enterprises for tax compliance purposes in New Zealand makes the comparison with other jurisdictions rather problematical.

To address this issues IR could align the definition of large enterprises for tax compliance purpose with criteria and thresholds used in the Financial Reporting Act (FRA) 2013 for

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<sup>25</sup> Eichfelder and Vaillancourt, above n 15, at 2.

<sup>26</sup> Tamer Budak, Simon James and Adnian Sawyer “International experiences of tax simplification and distinguishing between necessary and unnecessary complexity” eJournal of Tax Research (2016) 14 (2) 337, at 353.

<sup>27</sup> Above, at 337.

<sup>28</sup> See chapter 6, section 6.3.1.2 for the thresholds of significant enterprises.

financial reporting purposes. However, there is a problem concerning this suggestion. The FRA 2013 determines the size of an enterprise also on the basis of asset value, which implies that an enterprise with a turnover below the “significant” enterprise’s threshold turnover would be classified as a large provided the value of its assets meets the FRA 2013 threshold.<sup>29</sup> In this case, a certain number of enterprises would be classified as large but not “significant”. It is obvious that an attempt to align two definitions is fraught with difficulties.

In the researcher’s view, IR could use a set of qualitative criteria and apply them to a population of significant enterprises in order to establish the cut-off threshold for turnover after which significant enterprises exhibit convergence in the defined qualitative criteria. Furthermore, being clear about the cut-off threshold beyond which SMEs cease and large enterprises begin should significantly assist IR in analysing the cost effect of the adoption of the BEPS rules mentioned above.

### *7.6.3 Implications of Increasing Tax Planning*

Third, the fact that large enterprises engage in tax planning more often than SMEs and that the cost of tax planning tends to increase with the size of an enterprise<sup>30</sup> gives a rise to the following issues. Some of the studies on the cost of tax compliance<sup>31</sup> take a view that, although tax planning might be beneficial to enterprises, it reduces government revenue and, therefore appears to be a wasteful activity from societal point of view. At the same time, since tax planning is considered to be a part of tax compliance activity by both tax practitioners<sup>32</sup> and academics,<sup>33</sup> an increasing share of tax planning in the external services used by large enterprises is likely to drive cost of tax compliance. Therefore, these two factors suggest that tax planning, which large enterprises often resort to with an intention to maximise their profits

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<sup>29</sup> Financial Reporting Act 2013 (FRA 2013), s 45(1)(a).

<sup>30</sup> See Eichfelder and Vaillancourt above n 15, at 23.

<sup>31</sup> See, for example Binh Tran-Nam, Chris Evans, Michael Walpole and Katrine Ritchie “Tax Compliance Costs: Research Methodology and Empirical Evidence from Australia” (2000) 52 National Tax Journal 229, at 235.

<sup>32</sup> See sub-section 6.3.4 for tax practitioners’ responses about whether tax planning should be considered as a part of tax compliance.

<sup>33</sup> Chris Evans “Taxation Compliance and Administrative Costs: An Overview” in Michael Lang and others (eds) Tax Compliance Costs for Companies in an Enlarged European Community (Kluwer Law International, The Netherlands, 2007), at 452.

(as any rationally behaving economic agent is expected to do), results in a loss of tax revenue and increased cost of tax compliance.

One of the ways to discourage companies from engaging in tax planning is to levy a business income tax on a broad income tax base and at a low rate (BBLR). This policy was already adopted by New Zealand government and is applied by IR.<sup>34</sup> However, recently enacted BEPS initiatives are likely to prompt large enterprises to engage more in tax planning. For instance, one of the BEPS initiatives, the new permanent establishment (PE) anti-avoidance rule discussed in section 5.3.3, will most probably create incentives for multinational enterprises to restructure their business operations in order to avoid being caught in this rule. In this regard the BBLR model, which in part seeks to reduce tax planning incentives of large enterprises, and the BEPS rules aimed at curbing tax avoidance are likely to produce diametrically opposite effect on large enterprises' incentives to tax planning. Putting it differently, government takes actions in attempt to reduce tax planning incentives and at the same time stimulates them through introduction of new rules. According to Eichfelder and Schorn,<sup>35</sup> large enterprises' choices whether to engage in tax planning or not will largely depend on whether benefits from tax savings outweigh cost of tax planning.

A very important fact which should be considered in this regard is that the above discussion is based entirely on the premise that tax planning employed by large enterprises brings about only dead weight losses, which reduce overall social welfare. However, a more rigorous economic analysis<sup>36</sup> shows that the effect of tax planning on a social welfare is not so straightforward. Thus, Hong and Smart demonstrate that in high-tax rate countries tax planning might on the contrary lead to the increase in social welfare as tax planning allows maintaining high tax rates, while preventing outflow of foreign direct investment.<sup>37</sup> In a similar vein, they show that an increase in tax planning can lead to increase in both statutory and effective tax rates, which ultimately leads to the increased social welfare.

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<sup>34</sup> IR "The New Zealand tax system and how it compares internationally" (2017), at 3.

<sup>35</sup> Eichfelder and Schorn, above n 13, at 198.

<sup>36</sup> See, for example, Joel Slemrod and John D. Wilson "Tax Competition with Parasitic Tax Havens" (2009) 93 *Journal of Public Economics* 1261; Qing Hong and Michael Smart "In Praise of Tax Havens: International Tax Planning and Foreign Direct Investment" (2010) 54 *European Economic Review*.

<sup>37</sup> See Hong and Smart, above n 36, at 92.

What are the implications that the above discussion about tax planning of large enterprises may have for New Zealand tax policy? First, almost nothing is known about the magnitude of resources which are lost due to tax planning undertaken by large enterprises in New Zealand. Second, equally important factor which also needs to be considered is, how large are the social gains from imposing new tax rules, for example BEPS initiatives. The Inland Revenue could invest more time and efforts into investigating at least these two questions. After all, the answers to these questions are expected to provide valuable insights into both cost of tax planning incurred by large enterprises and whether tax planning undertaken by large enterprises is indeed so detrimental for the social welfare in New Zealand.

#### *7.6.4 Recommendations for Approaching Tax Practitioners and Large Enterprises for Conducting Interviews*

One of the recommendation arising from this study concerns the practical aspects of conducting interviews with external tax practitioners and staff in large enterprises. The researcher felt that his experience could provide some insights that could be beneficial for future researchers in the area of tax compliance of large enterprises and who are planning to use interview method.

The first recommendation is to focus on tax practitioners from the largest accounting firms (“Big Four”) as they are most likely to have direct exposure to working with large enterprises. One of the most efficient ways of getting tax practitioners to participate in an interview is to contact external professional organisations such as Chartered Accountants Australia and New Zealand (CA-ANZ) for the assistance in eliciting tax practitioners’ participation in an interview. As the researcher’s experience shows, contacting tax practitioners directly and asking them to participate turns out to be largely ineffective.

The second recommendation concerns the issue of limited time that tax practitioners have for participating in an interview. In the researcher’s experience, the average time each tax practitioner interviewed could give was about 25-30 minutes. In this regard, an interview guide should be designed in a way so that all the questions which a researcher plans to ask could be asked within a 20-25 minutes period. The remaining five minutes could be used in the case researcher needs to ask tax practitioners to clarify something. Asking tax practitioners to clarify what appears to be unclear during an interview is very important, as they rarely have time to come back with clarifications when contacted again after the interview.

The third recommendation relates to the method of approaching large enterprises. As outlined in the chapter five, sub section 5.4.2.3, it was initially planned to conduct interview with CFOs and tax managers of large enterprises. However, despite the researcher's attempts to contact large enterprises, none of the CFOs or tax managers contacted agreed to participate. In the researcher's opinion, this approach was ineffective as CFOs and tax managers of large enterprises probably saw little value of this study for their enterprises and also due to the considerable costs of their time. In this regard, prior to approaching large enterprises future researchers could have an endorsement from external organisations such as IR. Furthermore, the literature<sup>38</sup> also indicates that enlisting the support from a tax authority is essential for successful data collection process. Thus, in the studies on US and Australian enterprises presented in Chapter 2, the authors used support from the tax authority in their respective countries prior to approaching large enterprises. Apart from IR, obtaining support from professional organisations, such as, for example CA-ANZ, would also appear to be effective way to approach large enterprises.

### *7.7 Recommendations for Future Research*

The limitations outlined in the section 7.5 provide a foundation for future research in the area of the cost of tax compliance of large enterprises in New Zealand. In the researcher's view there are two main directions in which future research could follow. The first direction is the continuation of the qualitative research initiated in this study. The task of this research should expand the scope of explorative investigation into the costs of tax compliance of large enterprises, thereby providing more insights into aspects such as the magnitude, composition and determinants of tax compliance costs. To achieve these outcomes interviews with tax managers and CFOs of large enterprises could prove to be very helpful as a lot of information about large enterprises' internal and external costs could be elucidated from such interviews. Furthermore, since in the current study the effect of the industry factor on the costs of tax compliance of large enterprises was not investigated, identifying a sample of large enterprises from various industries, and conducting interviews with these large enterprises, would deepen our understanding of how industry may affect the costs of tax compliance of large enterprises.

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<sup>38</sup> See Slemrod and Blumenthal and Evans, Lignier and Tran-Nam, above n 2.



In addition, more interviews could be conducted with external tax practitioners in order to elicit their views on the effect of the industry factor on the costs of tax compliance.

A second direction for future research concerns undertaking a quantitative study of the costs of tax compliance of large enterprises in New Zealand. The first task of this research would be to define large enterprises, using criteria and thresholds identified in this study, and to determine a representative sample of large enterprises based on the definition adopted. This representative sample should include large enterprises from various industries thus capturing industry effect on the costs of tax compliance. The second task would be the choice of a data collection method. In line with previous studies,<sup>39</sup> large scale surveys conducted among large enterprises could be a method of data collection for this empirical research. The third task would be to estimate the magnitude of the costs of tax compliance in large enterprises and accordingly determine their composition. The contribution of the proposed research would be greater if regression analysis examining factors (determinants) influencing the magnitude of the costs of tax compliance in large enterprises is performed. For identification of the costs determinants, future research could rely on the findings of this and other previous studies on large enterprises, particularly studies undertaken in the US and Australia. This proposed future quantitative research could be a good method to test the validity of the findings made in this study in regard to the magnitude, composition and determinants of the costs of tax compliance in large enterprises.

As a further direction for future research, a study could be undertaken in order to estimate the magnitude of the unobservable costs of tax compliance of large enterprises in New Zealand. Estimation of unobservable costs of tax compliance would assist in elucidating whether large enterprises in New Zealand follow cost optimal tax compliance administration.

Both the future qualitative and quantitative research discussed above are anticipated to expand our knowledge of the costs of tax compliance of large enterprises in New Zealand and to provide greater insights into the factors influencing these costs. In comparison to the explorative nature of the present qualitative research, quantitative research would provide numerical estimations and accordingly allow generalisation of the results over the wider population of large enterprises in New Zealand. Therefore, in the researcher's view, conducting quantitative research would enable more accurate picture of the magnitude, composition and

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<sup>39</sup> See Slemrod and Blumenthal, above n 2; Evans, Lignier and Tran-Nam, above n 2.

determinants of the costs of tax compliance. Moreover, the results of the quantitative research of the costs of tax compliance of large enterprises in New Zealand could be compared with the results of the studies performed in other jurisdictions.

### *7.8. Concluding Remarks*

The aim of this study was to provide an explorative analysis of the costs of tax compliance of large enterprises from a New Zealand perspective. In addition, the study has explored criteria that can define large enterprises in New Zealand, and which can clearly set them apart from SMEs. Furthermore, this study introduced the concept of “significant” enterprises in New Zealand and outlined criteria that apply to classify enterprises as “significant”. By applying qualitative analysis, this study has found that income tax is likely to be the most costly tax for large enterprises to comply with. Second, it has found that the complexity of business operations carried out by large enterprises appears to be potential factor driving up the cost of tax compliance. Third, the study has revealed that the way large enterprises implement their tax compliance functions, and the composition of their external tax compliance costs, are different from SMEs. Given that this study represents one of the initial studies in the area of the costs of tax compliance of large enterprises in New Zealand, its findings are expected to provide insights and direction for the future research.

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## Appendices

### Appendix 1: Mathematical Model of the Rational Choice Theory

We can denote the net income that a rational business taxpayer strives to maximise with  $Y$ , which is obtained by reducing gross earnings  $E$ , by tax payments  $T$ , as well as by the costs of tax compliance  $C$ . These costs of tax compliance  $C$  also include costs of tax planning as suggested in the research literature.<sup>1</sup>

Tax burden  $T$  rises with gross earnings  $E$  and is reduced by the deductibility of tax compliance costs  $C$ . For simplicity, it is assumed that all tax compliance costs are deducted at the same tax rate. A business taxpayer also resorts to some specific tax planning options, denoted by  $O_k$ , as income shifting or use of an optimal depreciation method (for example diminishing value method). This tax planning option usually results in a lower tax payment, but higher costs of tax compliance due to the fact that tax planning costs are considered as a part of tax compliance costs  $C$ . Taking the above assumptions into consideration, the net income of the business taxpayer can be written as:

$$Y = E - T(E, C, O_k) - C \quad (1)$$

Three different types of compliance costs are considered in this model. These costs are:

- Personnel costs ( $C_p$ ) that result from using efforts of in-house personnel ( $R_p$ ). In-house personnel are assumed to perform such functions as record keeping, tax-filing, tax-planning and other tax related activities
- Capital costs ( $C_c$ ) that result from using capital ( $R_c$ ) by which a business taxpayer can substitute personnel resources

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<sup>1</sup> Sebastian Eichfelder and Michael Schorn “Tax Compliance Costs: A Business Administration Perspective” (2012) 68 FinanzArchiv: Public Finance Analysis 191 at 195.

- Costs of outsourcing tax activities to an external tax adviser ( $C_e$ ), where the usage of external resources (external tax adviser) is denoted by ( $R_e$ ).

For simplicity, it is postulated in the model that the marginal cost of external tax activities  $C_e'$  ( $R_e$ ) is constant and equal to the market price  $P_e$  that is,  $C_e' (R_e) = P_e$ . Furthermore, it is assumed that simple tax activities are executed first by in-house personnel before the business taxpayer turns for the assistance of external adviser regarding more complex and sophisticated tax activities. Hence, we can presume that the marginal costs of in-house tax compliance activities increases as the range of tax compliance activities grows. This relationship can be shown as:

$$C_p'' (R_p) > 0, \quad C_c'' (R_c) > 0$$

These assumptions should allow us to obtain an interior solution (a point where the isocost<sup>2</sup> line is tangent to isoquant<sup>3</sup> curve). This point of tangency gives the most optimal combination of resources used for fulfilling tax compliance obligations. The total tax compliance burden is therefore defined as:

$$C = C_p + C_c + C_e \quad (2)$$

Since the sum of resources expended on tax compliance should be enough to fulfil the amount of the tax compliance obligation, a business taxpayer faces the following constraint:

$$A (E, O_k) \leq \Theta \cdot R_p + \omega \cdot R_c + R_e \quad (3)$$

Here  $A (E, O_k)$  is the quantity of the necessary compliance activity, which in turn depends on the size of earnings ( $E$ ) and tax planning option ( $O_k$ ).  $\Theta$  is the efficiency parameter of the personnel-intensive tax compliance strategy and  $\omega$  is the capital intensive tax compliance

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<sup>2</sup> A line that represents all the combinations of firm's inputs that have the same total costs.

<sup>3</sup> A contour line that is drawn through all the possible combinations of input factors' amounts that generate the same level of output.

strategy. For simplicity, the production efficiency of the external tax advisers is postulated to be equal to 1.

According to the empirical literature,<sup>4</sup> the quantity of the tax compliance activity  $A(E, O_k)$ , which we can consider as the burden of tax compliance, is positively correlated with the size of the business. This in turn implies the positive correlation between  $A$  and pre-tax earnings  $E$ , which can be expressed mathematically as  $(\frac{\partial A}{\partial E} > 0)$ . Due to economies of scale the relative compliance costs burden decreases as pre-tax earnings increase, that is  $(\frac{\partial A^2}{\partial^2 E} < 0)$ .

Therefore, the tax compliance costs burden can be interpreted in this model as a kind of additional and regressive tax payment being deductible from the assessable income.<sup>5</sup> Furthermore, planning option  $O_k$  (for example, income-shifting) entails more tax compliance activity which implies a positive derivative  $(\frac{\partial A}{\partial O_k} > 0)$ .

Equipped with all these assumptions and having determined target function (1) and administration constraint (3), we can now move to obtaining the optimum solution by using the following Lagrangian function<sup>6</sup>:

$$L = E - T(E, C, O_k) - C_p - C_c - C_e - \lambda \cdot (A(E, O_k) - \Theta \cdot R_p - \omega \cdot R_c - R_e) \quad (4)$$

Here  $\lambda$  denotes the Lagrange multiplier.<sup>7</sup> The first order conditions with respect to resources  $(R_p)$ ,  $(R_c)$  and  $(R_e)$  as well as to specific tax option  $(O_k)$  will be as follows:

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<sup>4</sup> Binh Tran-Nam, and others “Tax Compliance Costs: Research Methodology and Empirical Evidence from Australia” (2000) 52 National Tax Journal 229 cited in Eichfelder and Schorn, above n 1, at 196.

<sup>5</sup> Eichfelder and Schorn, above n 1, at 196.

<sup>6</sup> See n 7 below for the explanation.

<sup>7</sup> Lagrange multiplier, named after Joseph Lagrange, is the mathematical method of finding local maxima and minima of a function that is finding such points where function is “locally” maximum or minimum, subject to equality constraint. For example:

$$\begin{aligned} &\text{maximize } f(x,y) \\ &\text{subject to } g(x,y) = 0 \end{aligned}$$

Therefore, Lagrange function or Lagrangian can be written as:

$$\partial L / \partial R_p = -C'p \cdot (1 + \frac{\partial T}{\partial C}) + \lambda \cdot \Theta = 0 \quad (5)$$

$$\partial L / \partial R_c = -C'c \cdot (1 + \frac{\partial T}{\partial C}) + \lambda \cdot \omega = 0 \quad (6)$$

$$\partial L / \partial R_e = -p_e \cdot (1 + \frac{\partial T}{\partial C}) + \lambda = 0 \quad (7)$$

$$\partial L / \partial O_k = -\partial L / \partial O_k - \lambda \cdot \partial A / \partial O_k \geq 0 \quad (8)$$

From the first order condition obtained optimal (cost-efficient) use of resource mix to comply with tax obligations can be derived as follows:

1. The optimal resource mix will be attained where the gross marginal cost of in-house resource unit will be equal market price of the external tax adviser:

$$\frac{c'_c}{\omega} = \frac{c'_p}{\theta} = p_e \quad (9)$$

Therefore, under the assumption of rational choice a business taxpayer will choose the cost-optimal mix of resources according to this condition.

2. Using (7) and (8) we can obtain the following relationship between tax compliance A, tax option  $O_k$  and the size of tax payment T:

$$p_e \cdot (1 + \frac{\partial T}{\partial C}) \cdot \partial A / \partial O_k + \partial T / \partial O_k \leq 0 \quad (10)$$

Hence this relationship implies that a cost minimising business taxpayer will use tax option ( $O_k$ ) until the moment when the marginal increase in tax compliance burden ( $\partial A$ ) will be greater than the marginal decrease in tax payment ( $\partial T$ ) caused by this tax option strategy.

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$L(x, y, \lambda) = f(x, y) - \lambda \cdot g(x, y)$ , where  $\lambda$  is Lagrange multiplier.

We need to find such  $(x_0, y_0, \lambda_0)$ , where the Lagrangian is maximized that is partial derivatives of L on  $x_0, y_0, \lambda_0$  are equal 0.

## Appendix 2: Interview Guide for Tax Practitioners

Purpose of the interview:

Specifically, the interview seeks to establish the following aspects:

- I. The magnitude, composition and general perception of the burden of tax compliance costs in large enterprises.
- II. The causes of tax compliance costs and factors influencing the magnitude of the tax compliance costs burden.
- III. Are tax planning, audit and tax disputes viewed as a part of the tax compliance activity?
- IV. How tax compliance administration is organized and is it efficient in reducing tax compliance costs at a large enterprise level?

The list of possible interview questions is presented next.

Possible interview questions

- I. This set of questions asks about the *magnitude, composition and general perception of tax compliance costs burden* of large enterprises

Q1. In general, what kind of tax-related services would a large enterprise purchase from your firm?

For example:

- A. Tax return preparation (business income tax, GST, FBT)
- B. Tax planning/tax advice
- C. Responding to IR claims and notices, dispute resolution
- D. Others



Q2. (In the case tax return preparation has been stated) Can you give the fee range that you would charge a large enterprise for the preparation of a tax return?

Q3. What type of taxes would require most of your time? What is the reason for the preparation of this tax return being so time-consuming? (Complexity, ambiguity of tax regulation, nature of the business, other)

Q.4 Of the tax services that you usually provide to large enterprises what is the percentage share of preparation of tax return service in your total fee for tax services?

Q.5. In your experience, what is the main difference (if there is any) between preparation of tax return for SMEs and large enterprises?

Q6. (In the case tax planning/tax advice has been named) What is your best estimate of the amount you would charge this firm for the tax planning/tax advice services?

Q7. Of the tax services that you usually provide to large enterprises, what is the percentage share of the tax planning/tax advice services in your total fee for tax services?

Q8. In your experience, do large enterprises usually require more tax planning/tax advice services compared to SMEs? What is the reason for that?

Q9. What aspects of taxation do most large enterprises seek tax planning and tax advice?

Q10. (In the case responding to IR claims and notices has been stated). Can you give the fee range that you would charge this firm for responding to IR claims and notices, and dispute resolution?

Q11. Of the tax services that you usually provide to large enterprises, what is the percentage share of the responding to IR claims and notices/ dispute resolution service in your total fee?

Q12. Compared to SMEs, do large enterprises frequently get involved in disputes with IR? What is the reason for that?

II. This set of questions asks about *the causes of the tax compliance costs burden of a large enterprise and factors driving these costs*

Q1. What aspect(s) of the current tax regulations is/are most responsible for the cost of large enterprises' complying with their tax obligation: business income tax, GST, FBT, PAYE and other kind of taxes?

Q2. In your opinion, what are the main factors driving costs of tax compliance in large enterprises?

Q3 In your experience, do costs of tax compliance change significantly, if a large enterprise has overseas subsidiaries (CFC) or investments in foreign entities (CFC or FIF) or simply engages in cross-border transactions?

Q4. What suggestions would you make to simplify current tax rules in order to reduce tax compliance costs for large enterprises?

III. This set of questions asks if the interviewee views *tax planning and tax disputes as a part of overall tax compliance of a large enterprise*.

Q1. Do you agree that tax planning should be viewed as a part of a large enterprise's overall tax compliance activity?

Q2. Do you agree that dealing with IR should be viewed as a part of a large enterprise's overall tax compliance activity?

IV. This set of questions asks interviewee about their opinion on whether costs of tax compliance in large enterprises can be reduced through *cost-efficient tax compliance administration*.

Q1. Can you explain how tax compliance administration is organized in large enterprises?

Q2. Is it typical for large enterprises to outsource some types of tax compliance activities while performing others in-house?

Q3. What is the rationale for such a strategy?

Q4. Do you believe that a part of tax compliance costs can be reduced through cost-efficient tax compliance administration?

Q5. From your perspective and drawing on your experience, do you believe that tax compliance administration in large enterprises is overall cost-efficient?

### **Appendix 3: Interview Guide for IR Official**

Below is the list of possible questions to ask an IR official about the definition of large enterprises and how the IR monitors compliance of large enterprises in New Zealand.

#### **I. Questions asking about definition of large enterprises:**

Q1. What current criteria the IR uses today to define large enterprises?

Q2. Is the majority of large enterprises in New Zealand are New Zealand based or foreign owned?

Q3. Is it correct to think that the majority of multinationals operating in New Zealand are large enterprises?

#### **II. Questions asking about methods the IR uses to monitor tax compliance of large enterprises?**

Q4. What areas of compliance of large enterprises does your unit monitor?

Q5. Do existing measures of monitoring tax compliance of large enterprises in New Zealand (submission of the Basic Compliance Package, binding ruling) effectively assist in preventing tax avoidance?

Q6. Is working closely with large enterprises effective for preventing tax avoidance?

Q7. How does communication between your unit and large enterprises happen? Do you communicate through tax manager of LE or external tax adviser?

Q8. What are the greatest difficulties that the IR sees in monitoring tax compliance of large enterprises in New Zealand? What does IR do in order to overcome address these issues?

Q9. Has IR or your unit done any research or survey to investigate how much large enterprises spend on submission of additional information requested by the IR, applying for binding rulings or Advanced Price Agreement?

## Appendix 4: Covering Letter to Tax Practitioners



**Department:** Accounting and Information Systems

**Email:** [nikolay.shekhovtsev@pg.canterbury.ac.nz](mailto:nikolay.shekhovtsev@pg.canterbury.ac.nz)

8 February 2018

Dear

My name is Nikolay Shekhovtsev and I am a PhD student in the Department of Accounting and Information Systems at the University of Canterbury.

As a part of my PhD program, I am seeking your assistance in understanding a crucial aspect of New Zealand taxation – the magnitude and extent of tax compliance costs borne by large enterprises. Being considered a hidden form of taxation, tax compliance costs serve as a proxy for measurement of the complexity of tax rules. Therefore, a thorough understanding of their magnitude and factors influencing them can provide a good insight into the burden caused by an (overly) complex tax system. In this regard, the purpose of my research is to investigate tax compliance costs in large New Zealand enterprises and therefore to contribute to this largely under-researched area.

I am writing to ask you if you could give me 35-45 minutes of your time to participate in an interview, during which you will be asked a number of questions about the magnitude, extent of tax compliance costs and factors influencing them in large enterprises. Your involvement is entirely voluntarily and you can withdraw from an interview at any time or decline to answer any given question. The content of the interview will be recorded for the subsequent transcription and analysis, provided you give your consent. Neither your name nor your organisation's name will be mentioned during the interview and therefore your participation (and that of your organisation) will remain confidential.

Additional information about research topic and interview is contained in the attached **Information Sheet** and **Consent Form**.

Your participation in the interview will be greatly appreciated. This is a great opportunity for you to contribute to exploring how the tax compliance environment for large enterprises in New Zealand could be made simpler and less burdensome.

Thank you very much,

Kind regards,

Nikolay Shekhovtsev

## Appendix 5: Covering Letter to IR Official



**Department:** Accounting and Information Systems

**Email:** [nikolay.shekhovtsev@pg.canterbury.ac.nz](mailto:nikolay.shekhovtsev@pg.canterbury.ac.nz)

8 February 2018

Dear

My name is Nikolay Shekhovtsev and I am a PhD student in the Department of Accounting and Information Systems at the University of Canterbury.

As a part of my PhD program, I am seeking your assistance in understanding a crucial aspect of New Zealand taxation – the magnitude and extent of tax compliance costs borne by large enterprises. Being considered a hidden form of taxation, tax compliance costs serve as a proxy for measurement of the complexity of tax rules. Therefore, a thorough understanding of their magnitude and factors influencing them can provide a good insight into the burden caused by an (overly) complex tax system. In this regard, the purpose of my research is to investigate tax compliance costs in large New Zealand enterprises and therefore to contribute to this largely under-researched area.

I am writing to ask you if you could give me 35-45 minutes of your time to participate in an interview, during which you will be asked a number of questions about how the IR defines large enterprises, what methods it uses in order to monitor tax compliance of large enterprises and whether current approach used by the IR is effective. Your involvement is entirely voluntarily and you can withdraw from an interview at any time or decline to answer any given question. The content of the interview will be recorded for the subsequent transcription and analysis, provided you give your consent. Your name will not be mentioned during the interview and therefore your participation will remain confidential.

Additional information about research topic and interview is contained in the attached **Information Sheet** and **Consent Form**.

Your participation in the interview will be greatly appreciated. This is a great opportunity for you to contribute to exploring how the tax compliance environment for large enterprises in New Zealand could be made simpler and less burdensome.

Thank you very much,

Kind regards,

Nikolay Shekhovtsev



## Appendix 6: Information Sheet and Consent Form for Tax Practitioners



Department: Accounting and Information Systems  
Email: [nikolay.shekhovtsev@pg.canterbury.ac.nz](mailto:nikolay.shekhovtsev@pg.canterbury.ac.nz)

8 February 2018

### ***The Costs of Tax Compliance for Large Enterprises: Application of a Conceptual Framework to New Zealand Large Enterprises***

#### **Information Sheet for interview participants**

My name is Nikolay Shekhovtsev and I am a PhD student in the Department of Accounting and Information Systems of the University of Canterbury. As a part of my PhD program, I am seeking your assistance in understanding a crucial aspect of New Zealand taxation – the magnitude and extent of tax compliance costs borne by large enterprises. Being considered a hidden form of taxation, tax compliance costs serve as a proxy for measurement of the complexity of tax rules. Therefore, a thorough understanding of their magnitude and factors influencing them can provide a good insight into the burden caused by an overly complex tax system. To date very little is known about the magnitude, composition and drivers of the tax compliance costs in large enterprises in New Zealand, as the focus of the previous research has been traditionally concentrated on small and medium scale enterprises. In this regard, the purpose of my research is to investigate tax compliance costs in large New Zealand enterprises and therefore to contribute to this largely understudied area.

If you choose to partake in this study, your involvement will be limited to taking part in an interview, during which you will be asked several questions about the magnitude, extent of tax compliance costs and factors influencing them in large enterprises. It is expected that the interview will last approximately 35-45 minutes. The content of the interview will be recorded for the subsequent transcription and analysis provided you give your consent. Neither your name nor your organisation's name will be mentioned during the interview and therefore your participation will remain confidential.

As a follow-up to this investigation, I may contact you later via e-mail simply for clarification of your answers. It will be entirely up to you whether to respond to this follow-up.

Participation is voluntary and you have the right to withdraw at any stage or decline to answer any

given question without penalty. You may ask for your raw data to be returned to you or destroyed at any point. If you withdraw, I will remove information relating to you. However, once analysis of raw data commences, it will become increasingly difficult to remove the influence of your data on the analyzed results. The results of the project may be published, but you may be assured of the complete confidentiality of data gathered in this investigation: your identity will not be made public. To ensure anonymity and confidentiality, your answers will be assigned a code and no real names will be used in the process of interview and subsequent analysis. All audio records will be immediately destroyed upon completion of the interview transcription. The file with the transcribed text will be securely stored on my university desk computer under my account name and protected by the password known to me only. There will be only three people, two of my academic supervisors and me, who will have an access to this data. This will guarantee the integrity and confidentiality of the interview data. A thesis, which will include analysis of the data, is a public document and will be available through the UCLibrary. However, as has been mentioned earlier, no names will be revealed in the thesis.

However, please be aware that in spite of all the precautionary measures to protect the identity of your enterprise described above, there is a possibility that your enterprise could be associated with the obtained data due to the small number of large enterprises in New Zealand. This possibility is beyond the researcher's control and should be considered as an inherent risk.

The copy of any ensuing publication, thesis or presentation in which reference will be made to the interview data, will be provided to you should you so request.

The project is being carried out as a requirement for PhD degree by Nikolay Shekhovtsev under the supervision of Professor Adrian Sawyer and Associate Professor Andrew Maples who can be contacted at [adrian.sawyer@canterbury.ac.nz](mailto:adrian.sawyer@canterbury.ac.nz) and [andrew.maples@canterbury.ac.nz](mailto:andrew.maples@canterbury.ac.nz). They will be pleased to discuss any concerns you may have about participation in the project.

This project has been reviewed and approved by the University of Canterbury Human Ethics Committee, and participants should address any complaints to The Chair, Human Ethics Committee, University of Canterbury, Private Bag 4800, Christchurch ([human-ethics@canterbury.ac.nz](mailto:human-ethics@canterbury.ac.nz)).

If you agree to participate in the study, you are asked to complete the consent form and return the signed form to the following email address: [nikolay.shekhovtsev@pg.canterbury.ac.nz](mailto:nikolay.shekhovtsev@pg.canterbury.ac.nz)

*Nikolay Shekhovtsev*

Nikolay Shekhovtsev  
Ph.D Candidate  
Department of Accounting and Information Systems  
University of Canterbury  
Christchurch

*A J Sawyer*

Dr Adrian Sawyer  
Professor of Taxation  
Department of Accounting and Information Systems  
University of Canterbury  
Christchurch

*A J Maples*

Andrew Maples  
Associate Professor of Taxation  
Department of Accounting and Information Systems  
University of Canterbury  
Christchurch

Department Accounting and Information Systems  
Email: [nikolay.shekhovtsev@pg.canterbury.ac.nz](mailto:nikolay.shekhovtsev@pg.canterbury.ac.nz)

***The Costs of Tax Compliance for Large Enterprises: Application of a  
Conceptual Framework to New Zealand Large Enterprises***

**Consent Form**

*Include a statement regarding each of the following:*

- ☐ I have been given a full explanation of this project and have had the opportunity to ask questions.
- ☐ I understand what is required of me if I agree to take part in the research.
- ☐ I understand that participation is voluntary and I may withdraw at any time without penalty. Withdrawal of participation will also include the withdrawal of any information I have provided should this remain practically achievable. In addition, I may refuse to answer any given question without penalty.
- ☐ I have been advised about inherent risks associated with this research.
- ☐ I understand that any information or opinions I provide will be kept confidential to the researcher and his academic supervisors and that any published or reported results will not identify the participants and their organisation. I understand that a thesis is a public document and will be available through the UC Library.
- ☐ I understand that all data collected for the study will be kept in locked and secure facilities and/or in password protected electronic form and will be destroyed after ten years.
- ☐ I understand that I can contact the researcher or his supervisors for further information. If I have any complaints, I can contact the Chair of the University of Canterbury Human Ethics Committee, Private Bag 4800, Christchurch ([human-ethics@canterbury.ac.nz](mailto:human-ethics@canterbury.ac.nz))
- ☐ I would like a summary of the results of the project.
- ☐ By signing below, I agree to participate in this research project.

Name: \_\_\_\_\_ Signed: \_\_\_\_\_ Date: \_\_\_\_\_

Email address (for report of findings, if applicable): \_\_\_\_\_

---

[Please email the signed form to [nikolay.shekhovtsev@pg.canterbury.ac.nz](mailto:nikolay.shekhovtsev@pg.canterbury.ac.nz)]

## Appendix 7: Information Sheet and Consent Form for IR Official



Department: Accounting and Information Systems  
Email: [nikolay.shekhovtsev@pg.canterbury.ac.nz](mailto:nikolay.shekhovtsev@pg.canterbury.ac.nz)

8 February 2018

### ***The Costs of Tax Compliance for Large Enterprises: Application of a Conceptual Framework to New Zealand Large Enterprises***

#### **Information Sheet for interview participants**

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Participation is voluntary and you have the right to withdraw at any stage or decline to answer any

given question without penalty. You may ask for your raw data to be returned to you or destroyed at any point. If you withdraw, I will remove information relating to you. However, once analysis of raw data commences, it will become increasingly difficult to remove the influence of your data on the analyzed results. The results of the project may be published, but you may be assured of the complete confidentiality of data gathered in this investigation: your identity will not be made public. To ensure anonymity and confidentiality, your answers will be assigned a code and no real names will be used in the process of interview and subsequent analysis. All audio records will be immediately destroyed upon completion of the interview transcription. The file with the transcribed text will be securely stored on my university desk computer under my account name and protected by the password known to me only. There will be only three people, two of my academic supervisors and me, who will have an access to this data. This will guarantee the integrity and confidentiality of the interview data. A thesis, which will include analysis of the data, is a public document and will be available through the UC Library. However, as has been mentioned earlier, no names will be revealed in the thesis.

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***Nikolay Shekhovtsev***

Nikolay Shekhovtsev  
Ph.D Candidate  
Department of Accounting and Information Systems  
University of Canterbury  
Christchurch

***A J Sawyer***

Dr Adrian Sawyer  
Professor of Taxation  
Department of Accounting and Information Systems  
University of Canterbury  
Christchurch

***A J Maples***

Andrew Maples  
Associate Professor of Taxation  
Department of Accounting and Information Systems  
University of Canterbury, Christchurch

Department Accounting and Information Systems  
Email: [nikolay.shekhovtsev@pg.canterbury.ac.nz](mailto:nikolay.shekhovtsev@pg.canterbury.ac.nz)

***The Costs of Tax Compliance for Large Enterprises: Application of a  
Conceptual Framework to New Zealand Large Enterprises***

**Consent Form**

*Include a statement regarding each of the following:*

- ☐ I have been given a full explanation of this project and have had the opportunity to ask questions.
- ☐ I understand what is required of me if I agree to take part in the research.
- ☐ I understand that participation is voluntary and I may withdraw at any time without penalty. Withdrawal of participation will also include the withdrawal of any information I have provided should this remain practically achievable. In addition, I may refuse to answer any given question without penalty.
- ☐ I have been advised about inherent risks associated with this research.
- ☐ I understand that any information or opinions I provide will be kept confidential to the researcher and his academic supervisors and that any published or reported results will not identify the participants and their organisation. I understand that a thesis is a public document and will be available through the UC Library.
- ☐ I understand that all data collected for the study will be kept in locked and secure facilities and/or in password protected electronic form and will be destroyed after ten years.
- ☐ I understand that I can contact the researcher or his supervisors for further information. If I have any complaints, I can contact the Chair of the University of Canterbury Human Ethics Committee, Private Bag 4800, Christchurch ([human-ethics@canterbury.ac.nz](mailto:human-ethics@canterbury.ac.nz))
- ☐ I would like a summary of the results of the project.
- ☐ By signing below, I agree to participate in this research project.

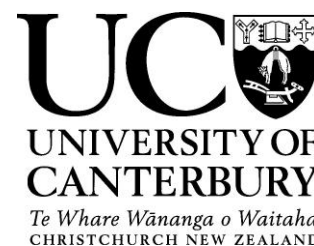
Name: \_\_\_\_\_ Signed: \_\_\_\_\_ Date: \_\_\_\_\_

Email address (for report of findings, if applicable): \_\_\_\_\_

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[Please email the signed form to [nikolay.shekhovtsev@pg.canterbury.ac.nz](mailto:nikolay.shekhovtsev@pg.canterbury.ac.nz)]

## Appendix 8: Human Ethics Approval



HUMAN ETHICS COMMITTEE  
Secretary, Rebecca Robinson  
Telephone: +64 03 369 4588, Extn 94588  
Email: [human-ethics@canterbury.ac.nz](mailto:human-ethics@canterbury.ac.nz)

Ref: HEC 2017/141

12 January 2018

Nikolay Shekhovtsev  
Accounting and Information Systems  
UNIVERSITY OF CANTERBURY

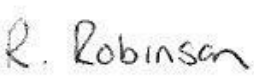
Dear Nikolay

The Human Ethics Committee advises that your research proposal “The Costs of Tax Compliance for Large Enterprises: Application of Conceptual Framework to a New Zealand Case Study” has been considered and approved.

Please note that this approval is subject to the incorporation of the amendments you have provided in your email of 8<sup>th</sup> January 2018.

Best wishes for your project.

Yours sincerely

  
pp.

Professor Jane Maidment